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Condominium Workshop

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CONDOMINIUM WORKSHOP

The St. John's Law Review Association sponsored a Condominium Workshop on October 26, 1973 at the New York Hilton Hotel. Its purpose was to present an overview of the condominium field from various perspectives and to direct the practitioner to significant developments in the area. The participants in the workshop were: Professor Patrick J. Rohan, Professor of Law, St. John's University, co-author of *Condominium Law and Practice* and co-author of the *Condominium Report*; Hon. Arthur Levine, Assistant Director of the Bureau of Securities and Public Financing of the Department of Law of the State of New York, who is in charge of the Condominium and Co-operative Section at the Attorney General's Office; Thomas H. Fegan, Associate General Counsel to the Equitable Life Assurance Society; and William H. Parry, a member of the firm of S. M. & D. E. Meeker, Counsel to the Williamsburg Savings Bank.

The following is an edited and annotated transcript of the workshop. An appendix, containing the original outlines prepared by the speakers, follows the text.

PROFESSOR ROHAN: Today's speakers wish to direct their remarks to particular problems that directly concern your practice. I will present introductory remarks on the problems that I have observed in the condominium field that may be of interest to you as counsel for people constructing condominiums, as counsel for purchasers of condominiums, or as counsel for various lending institutions. Additionally, I will try to give you an overview of current developments in the condominium field. After this initial presentation, Arthur Levine will field the subject of condominium registration. More particularly, he will outline the New York Attorney General's registration and market testing procedures and discuss the situation of a non-New Yorker developing an out-of-state project who wants to advertise in New York.

This afternoon we will spend a segment of time on commercial and industrial condominiums, which is currently the largest single area in the condominium field in terms of new interest, most notably because of the growth of medical office condominiums. Thomas Fegan will be discussing construction lending on condominium projects, and

William Parry will be speaking on mortgaging in general and some of the problems he sees on the horizon.

Let's take a look at what is happening in the condominium field and some of the problems that I see around right now. By way of available literature, there is the three volume legal treatise called *Condominium Law and Practice*.¹ It represents a useful source of information concerning condominiums and is available in various law libraries. Over the years we have collected an assortment of condominium documents — condominiums based on a leasehold, medical office and shopping center condominiums, industrial condominiums, multiple condominiums with a recreation association and an overall umbrella association, and so on. There are roughly a dozen complete sets of forms in the back of the book. There is also a complete bibliography which is updated annually. Also included in the treatise is a chapter devoted to representing the condominium purchaser — what must you do and to what extent it is different from representing the purchaser of a one-family home.

If you are practicing in Connecticut, I would just mention that filing requirements have been proposed for that state.² Although these requirements are not as detailed as New York's, Connecticut currently has a set of registration forms. In addition, the Connecticut Bar has published a work entitled the *Connecticut Condominium Manual*.³ In it, individuals associated with savings banks, title companies and law firms jointly created a fictional condominium project. Based upon this hypothetical project, a complete set of condominium documents, including financing, mortgage and insurance forms were created with the assistance of a computer. If you are in New Jersey, many of that state's filing requirements are similar to those of New York.⁴ Arthur, what is the interplay between New York and New Jersey as far as registrations go?

ARTHUR LEVINE: New Jersey does not require the registration of condominium offering plans except, I believe, if it involves the retirement communities. If you submit your new retirement condominium plans to the State of New Jersey Security Office, they will refuse to process it. However, if it is geared to senior citizens, there is a requirement to file an offering statement with the Department of Community

¹ P. ROHAN & M. RESKIN, *CONDOMINIUM LAW & PRACTICE* (1965) [hereinafter cited as ROHAN & RESKIN].

² See generally CONN. GEN. STAT. REV. §§ 47-71, -80 (1973).

³ See also Connecticut Bar Association, *AN ANALYSIS OF CURRENT CONDOMINIUM PROBLEMS AND OPPORTUNITIES FOR CONNECTICUT PRACTITIONERS* (1971).

⁴ See N.J. REV. STAT. § 46:8B-9 *et seq.* (Supp. 1973).

Affairs, 363 West Street, Trenton, New Jersey. And there is, of course, a separate statute in New Jersey dealing with retirement communities.

PROFESSOR ROHAN: At this point it is appropriate to examine the problems arising from new construction of condominiums, whether the attorney is representing the developer or the purchaser. At the outset, it is important to note the almost total lack of state regulation of condominium developments. Only a handful of states, Arizona, California, Florida, Hawaii, Illinois, Michigan, and New York, regulate the offering for sale of condominiums.⁵

One of the things that I think will come back to haunt developers in the condominium field is misleading or inadequate advertising. For example, a developer seeking to convert a townhouse may claim that a current lessee could carry the unit following conversion for the amount he is now paying in rent. By aggregating common expenses, real estate taxes and projected mortgage charges, the developer,

⁵ Arizona treats the condominium regime as a subdivision and accordingly requires the developer, whether he seeks to sell or lease units, to complete a questionnaire developed by the State Real Estate Department. Based upon the information contained in the questionnaire and supporting documents, the State Real Estate Commissioner prepares and issues a report on the development. He may prohibit the sale or lease of the property, but any such order must be preceded by a hearing. *See* ARIZ. REV. STAT. ANN. § 32-2181 *et seq.* (Supp. 1973).

Pursuant to statute, condominiums in California are deemed "subdivisions." As a consequence, condominium developers must comply with the statutory requirements imposed upon developers of subdivided lands. CAL. BUS. & PROF. CODE § 11004.5 (West Supp. 1974). The developer must file with the Commissioner of Real Estate notice of intention to sell or lease the property. CAL. BUS. & PROF. CODE § 11010 (West Supp. 1974). Following this application, the commissioner investigates the subdivision proposal and either accepts or rejects it. CAL. BUS. & PROF. CODE § 11018 (West Supp. 1974). Thereafter, if the developer does not fulfill the representations contained in the application, the commissioner may order him to discontinue the complained of practice, or cease selling or leasing subdivision property. CAL. BUS. & PROF. CODE § 11019 (West Supp. 1974). In addition, the California Commissioner of Corporations has authority to regulate condominiums under the Corporate Securities Law of 1968. CAL. CORP. CODE § 25000 *et seq.* (West Supp. 1974).

Florida has recently enacted a full disclosure act, which enumerates the type of information which must be available to prospective purchasers prior to the initial sale or offering for sale of a condominium. FLA. STAT. ANN. § 711.24 (Supp. 1974).

According to regulations adopted by the Real Estate Commission of Hawaii, a developer prior to offering condominium units for sale must file a "notice of intention" along with responses to a questionnaire developed by the Commission. Based upon this information, the Commission issues a public report concerning the proposed sale. 1 ROHAN & RESKIN § 7.02[2][c], at 7-17.

In 1972 Illinois added to its condominium legislation a full disclosure act which requires a developer to reveal details concerning the project's bylaws, declaration, projected operating budget and floor plan of the offered unit prior to the "initial sale or offering for sale of any condominium unit." ILL. ANN. STAT. ch. 30, § 322 (Smith-Hurd Supp. 1973).

Michigan law requires a developer to make application for and receive from the State Corporations and Securities Commission a permit to sell before condominium apartment units are offered for sale. MICH. COMP. LAWS ANN. § 559.26 (1967). *See generally* 1A ROHAN & RESKIN app. 11 *et seq.*

by way of illustration, might come up with a figure of \$230.00 per month. But the developer may not be disclosing the fact that the unit owner will have to pay his own utility bills. Many developers choose to separately meter the electric, gas and water services to the individual unit in order to reduce the common charge. For example, I recollect one instance in which a unit's electric heat was separately metered. It is therefore quite conceivable that the individual who believes he can carry a unit for \$230.00 per month may be unaware of the fact that he will have separate utility charges. To lessen the likelihood of such a situation developing where utilities are to be separately metered, it is incumbent upon the developer's counsel to indicate to potential purchasers the extent to which a unit's projected living expenses will exceed the advertised common charge.

Another defect along these lines is underestimating the common charge. In the case of a conversion, unintentional underestimating need not be a serious problem in New York because the developer must supply the Attorney General's office with a record of the last three years' operating history of the building.⁶ Using this information as a base line, the developer can add to these previous operating expenses an inflation factor of 10 percent. As a precaution he should factor in an additional 10-15 percent since it is better to overestimate than to underestimate the common charges in the first year's budget. As a recent Illinois case suggests, a developer may be held liable in fraud for intentionally underestimating common expenses. In this connection, it is pertinent to observe that the filing of the offering plan does not end the developer's responsibility in New York. Should information come to the attention of the developer which would affect the common charges or projected first year budget, he is obligated to amend the offering plan. The developer's duty in this regard is not diminished or eliminated by the acceptance of the plan by the Attorney General's office or its subsequent dissemination.

In light of this problem of misleading representations, it is important to note that there have been a number of lawsuits recently wherein courts throughout the United States have recognized class actions brought by homeowners or purchasers in planned unit developments. Class actions have been successfully maintained both by homeowners associations and individuals bringing suit on behalf of all those similarly situated. More specifically, in two recent New York

⁶ See Regulations Pursuant to the New York Condominium Act, 13 N.Y.C.R.R. § 19.2 (b)(2)(z) (1964) *reprinted in* 1A ROHAN & RESKIN app. 19.

decisions the right to maintain a class action in connection with co-operative offering plans was recognized.⁷

Many developers decide to take back a management contract for a minimum of three years in order to insure that the project is properly operated during the period the developer is selling the remaining units. If the developer has management experience and can achieve economies in the operation of the condominium through bulk purchases, he may be able to operate the project at a substantially lower cost than individual unit owners coming together to operate a large scale real estate development for the first time.

During the start-up of the condominium regime the absence of a reserve fund can restrict the flexibility of the project. Such a limitation is often avoided by requiring individual buyers to contribute three months common charges at the time of purchase. This represents a one-time contribution to capital, enabling the infant condominium to generate \$5,000 or \$10,000 of needed resources. This requirement can be justified by considering the position of a new condominium without a reserve fund. Should an emergency arise, the unit owners will be assessed within thirty days for the emergency-related expenses. An existing reserve fund would eliminate the necessity of such an assessment.

In the conversion area, the developer has to decide whether to bring the building up to first class standards by making any and every possible repair, including cosmetic repairs such as painting the lobby and refurbishing the elevator. Alternatively, the condominium sponsor might choose to make a contribution to the project's capital fund, rather than embarking upon a "touch-up" campaign. The advantage of this course is that it will not subject the developer to subsequent charges by unit owners that the cosmetic improvements were only superficial and masked underlying physical defects. A building owner may be inclined to make these superficial improvements on the basis of simple economics: he may be able to realize a significant profit on such improvements. Nonetheless, in my judgment there is much to be said for refraining from making these marginal changes. Instead, it would be wiser for the building owner to calculate how much it would cost to bring the building "up to snuff," including the cosmetic improve-

⁷ See *Richards v. Kaskel*, 32 N.Y.2d 524, 300 N.E.2d 388, 347 N.Y.S.2d 1 (1973); *Grenader v. Lefkowitz*, 71 Misc. 2d 414, 336 N.Y.S.2d 355 (Sup. Ct. New York County 1972). *But cf.* *Tuvim v. 10 E. 30 Corp.*, 32 N.Y.2d 541, 300 N.E.2d 397, 347 N.Y.S.2d 13 (1973).

ments. On the basis of such an estimate, the building owner could propose to make a one-time contribution to the building's capital fund and include this proposed donation in the offering plan. Appended to such an offer should be a warning that this one-time contribution to capital does not necessarily represent sufficient financing to bring the building up to an optimum condition. Even where an initial capital contribution is made, it would be prudent to require each unit owner to contribute a sum equivalent to three months' carrying charges. In practice, the owner's contribution is often dissipated rapidly, typically to make repairs suggested in the engineer's report. Hence, without an existing reserve fund, even where the building owner has made a capital donation, a new condominium may very well have no financial cushion. I would suggest that this three-month advance contribution be brought clearly to the purchaser's attention. It should be highlighted by way of underscoring or boldface print. As a further precaution, the advance contribution requirement could be stated in several places in the offering plan — perhaps as a footnote to the budget, as well as in the statement of unit acquisition costs. I have observed on several occasions purchasers coming to closings without being informed by their attorney of the advance contribution. Their attorney might have explained the down payment, the mortgage, and the bank's charges, but not have said anything about the contribution of three months carrying charges. If, for example, the monthly carrying charges are \$100.00 and you tell a client at the closing that he needs another check for \$300.00 as a one-shot contribution to capital, he may understandably get upset. Again, many of the purchasers will ask, "When do I get it back? Is it held in escrow?" etc. You should underscore the fact that it is a single, nonrecurring contribution to capital, that it is not to be held in escrow and that the board of managers can use it for any purpose they deem appropriate. Of course, if the purchaser wishes eventually to get the money back, he could just add \$300.00 (or whatever sum was required) to his eventual asking price five years hence when he resells the unit. Other than that, he has no right to be reimbursed for his advance contribution.

You may have read much about the SEC aspects of condominiums in the last several months. Typically most condominiums will not be subject to SEC requirements. The condominium per se is real estate. However, let us assume that you are selling a condominium in the Bahamas or a ski chalet in Colorado and as part of your promotional literature you state that when the owner is not on the premises, it can be rented. The promotion might go something like this: you, as the

owner, may decide to use the chalet four weeks a year; during the remainder of the season, or year, we, acting as the condominium management, will rent out the chalet for you, thus generating some income from the property. If you are doing that and supplying a rental service, it is fairly certain that you will come under SEC jurisdiction and you must file with the SEC. Another variant of a management group functioning as a rental agent is the establishment of a noncompetitive rental pool among the various unit owners. A central office systematizes the rental process by renting out units in sequence, assuring that every member's unit is subjected to wear and tear. More important, each member of the pooling agreement gets a portion of the aggregate rental income no matter how successful or unsuccessful the central office is in renting his particular unit. Predictably, the noncompetitive component of such an arrangement is a major selling point. If a developer takes back a management contract and from the outset makes a rental service available, he will be within the purview of SEC authority. Conversely, if the developer merely markets the units, with no rental pool offered as an incentive to purchase, it is extremely unlikely that the project will come within SEC jurisdiction.

A more pressing problem is found in the Interstate Land Sales Full Disclosure Act.⁸ That Act was passed five years ago by Congress primarily to thwart fraudulent practices in interstate sales of land. There was no intention on the part of Congress to regulate condominiums, but the Department of Housing and Urban Development has stipulated in their most recent set of regulations that the condominium will come under the Interstate Land Sales Full Disclosure Act regulation if the unit will not be completed within two years or if significant recreational or other common facilities are being constructed which will not be completed within two years from the time the first purchaser signs a contract.⁹

Over the past several years many developers have placed in their contracts a stipulation that if for any reason the condominium unit is not completed within two years from the contract date, the prospective purchaser can receive a full refund on his down payment. Although such a provision is designed to nullify the impact of the Interstate Land Sales Full Disclosure Act, it is a worthwhile element of a condominium purchase agreement. It should be included even if the developer intends to complete the project well within the two year period.

⁸ 15 U.S.C. § 1701 *et seq.* (1970).

⁹ 38 Fed. Reg. 27,227 (1973); 38 Fed. Reg. 23,866 (1973).

While we are on the subject of statutes affecting condominiums, the question of the authority of the board of managers to borrow money is relevant. New York's condominium statute will serve to illustrate the problems in this area. The statute contemplates the board of managers developing an annual budget.¹⁰ One may reasonably read the New York law as requiring that normal budget items are to be financed through common charges, while extraordinary needs are to be taken care of through the use of special assessments. By inference, one might very well conclude that neither the condominium association nor the board of managers has the authority to borrow money. Arthur, have you seen anything on that?

ARTHUR LEVINE: Frankly, no. It is going to be a very serious problem. I do not think that under the statute itself, as presently worded, the board could borrow money. The only thing I think you can do is incur liability in terms of purchasing services on personal property and pay for those services. I have not seen any situation where they are specifically authorized to borrow money. This does, however, raise the question of whether the board of managers should incorporate. If the board of managers chooses to incorporate, should not that corporation have the usual power to borrow as do other corporations? The board of managers owns nothing as such — it is the unit owner who owns the unit and the common elements and, of course, there are restrictions in the statute as far as creating liens on the common elements, etc. Thus from a strictly commercial viewpoint it is very difficult to see how the board of managers, itself, would be creditworthy except through their authority to raise money by assessing the unit owners.

PROFESSOR ROHAN: There have been at least two loans that I am aware of where condominium boards of managers borrowed money from local savings banks in the range of \$3,000 to \$5,000 and in these situations, the board did not get consent — they simply borrowed unilaterally.

ARTHUR LEVINE: I think it would violate the condominium principle if we could blanket liens for a failure to pay and hurt a neighbor who could pay up because some other neighbor did not pay up. So I do not think we should permit it.

PROFESSOR ROHAN: There is one set of circumstances which might permit a board of managers to borrow. If, for example, the condominium documents authorized the board to expend up to \$5,000

¹⁰ See N.Y. REAL PROP. LAW § 339-v(f) (McKinney 1968).

without the express approval of the unit owners' association and a contractor demanded a full or substantial cash prepayment before he commenced work on the condominium, the board might argue that it impliedly had authority to borrow the needed money. The argument would be that in terms of board authority there is no real difference between waiting for monthly unit assessments to generate the required sum and borrowing now in order to meet a contractor's demands. In either event, an expenditure within the range that the board may authorize on its own will be made. That is the only conceivable legal argument I can stitch together, but I think it is stretching a point.

At this time, I would like to introduce the Honorable Arthur S. Levine.

ARTHUR LEVINE: Simultaneously with the enactment of the New York Condominium Act,¹¹ the legislature enacted the Martin Act.¹² A body of statutory and case law rules and regulations originally intended to protect the residents of the state from fraud in the sales of securities thereby became equally applicable to condominiums offered in or from the State of New York. The Martin Act and the Blue Sky Laws are used interchangeably. This adhesion of the Martin Act to condominiums was accomplished by including in the New York Condominium Act at section 339(ee) of the Real Property Law, which deals with the effects of other laws, the following language:

All units of a property which shall be submitted to the provisions of this article [Article 9-B of the Real Property Law] shall be deemed to be cooperative interests in realty within the meaning of section three hundred fifty-two-e of the General Business Law.¹³

Section 352(e) is part of Article 23(a) and it is sometimes referred to as the Full Disclosure Law. This section requires the filing of an offering plan or statement or prospectus with the Department of Law before any unit of a condominium may be offered for sale to a resident of the state. However, the Full Disclosure Law does much more than that. Pursuant to section 352(j) of the General Business Law, all other provisions of the Martin Act are applicable to cooperative interests in realty and thus to condominiums offered within or from the State of New York. I would like to briefly explore the scope of the Martin

¹¹ *Id.* § 339-d *et seq.*

¹² N.Y. GEN. BUS. LAW § 352 *et seq.* (McKinney 1968).

¹³ N.Y. REAL PROP. LAW § 339-ee(1) (McKinney 1968).

Act because it rounds out the dimensions of our concern; it is what we look for not only in terms of the full disclosure but in terms of other provisions of the Martin Act.

To understand the Martin Act, you have to know that the Attorney General is authorized to make an investigation of any security offering, including condominiums, merely on a complaint of anyone or upon his own initiative.¹⁴ He has the power to subpoena witnesses and documents.¹⁵ He may bring an action to enjoin the offering of a sale in New York of unregistered condominiums whether located within or outside of New York State.¹⁶ He may bring misdemeanor charges for violation of the Martin Act against any person or persons engaged in the offering for sale of unregistered condominiums or the commission of fraudulent practices in relation to the sale of registered condominiums.¹⁷ Under the Martin Act the sponsors and sellers of condominium units *must* register with the Department of Law as broker-dealers of securities.¹⁸ Persons with felony records may be barred from selling condominiums. We do have a few builders and promoters with felony records and if one of them happens to be your client, be sure that you check his background to see to it that he is not barred from the sale of condominiums in the State of New York. I would suggest that as a practical matter it is one of the things you ought to speak about at an early stage and get in touch with our office and provide us with background materials so that we can make a judgment as to whether or not his felony record will bar him from offering condominiums in the State of New York. Sponsors and selling agents are subject to the net minimum capital requirement of \$5,000 which is intended to prevent undercapitalized persons or corporations from engaging in the securities business.¹⁹

The Martin Act defines fraudulent practices in the sale of securities, and therefore condominiums, as any device, scheme, artifice, fictitious or pretended sales deception, misrepresentation, concealment, suppression, etc.²⁰ Under the Act it is a misdemeanor to make an offering for sale of securities on the basis of any promise or representation as to the future, which is beyond reasonable expectations or unwarranted by existing circumstances; and making any representation or statement

¹⁴ N.Y. GEN. BUS. LAW § 352 (McKinney 1968).

¹⁵ *Id.* § 352.

¹⁶ *Id.* § 352-i.

¹⁷ *Id.* § 358.

¹⁸ *Id.* § 359-e.

¹⁹ *Id.* § 352-k.

²⁰ *Id.* § 352-c.

which is false where the person making such representation or statement knew the truth or with reasonable effort could have known the truth and makes no reasonable effort to ascertain the truth or did not have any knowledge concerning the truth of the statement or representations that he makes, also constitutes a misdemeanor.²¹ This recital is intended to provide background in understanding the registration procedures and requirements. The scope of the Martin Act is well known to lawyers engaged in securities practice but is unfamiliar to those whose primary source of income is real property transactions. This fact should no more deter the real property practitioner from representing the sponsor of a condominium plan or the buyer of a condominium unit than it should deter securities practitioners who must acquire expertise in the law of real property. Real property law governs the substance of the condominium transactions and the Martin Act governs the marketplace.

In all likelihood your first experience with condominiums will, or already has, involved representation of a purchaser of a condominium unit. A much smaller percentage may represent the sponsor, the lending institution, the broker, or the sales agent of a new condominium or a rental building being converted to condominium ownership. In any event, an understanding of the registration procedure will enable you to provide more effective representation for your client. The essential virtues of an attorney in making his first registration are time and patience. The sooner you start your work, the more time you have and the more patience you can afford to exhibit. Know the physical, legal, construction and financial dimensions of your client's plan.

Read the Condominium Act, Section 352(e) of the General Business Law, and the Condominium Regulations. There are a number of helpful works in this area including P. Rohan & M. Reskin, *Condominium Law and Practice*; D. Clurman & E. Hebard, *Condominiums and Cooperatives*; and D. Clurman, *Business Condominiums*.

Examine an offering plan which has already been accepted for filing by the Department of Law. Look at the real estate supplement of the New York Times or other newspapers. If you see an ad for a condominium which interests you, examine the offering plan. There are ways of getting it: firstly, Cooperative Policy Statement No. 2 issued by the Attorney General requires that the sponsor of a condominium issue an offering plan to anyone who wants it, provided that individual

²¹ *Id.* § 352-c.

is prepared to place a refundable \$50.00 deposit for the booklet. When you return that offering plan, you are entitled to the return of your \$50.00. The reason for this policy is obvious. Offering plans may contain 195-200 pages and are quite expensive to reproduce, and if you are going to hand this out to every child that comes by with his parent, you're going to go broke in a very short time.

If you find that you would like to look at an offering plan in our office, write to us and give us the name of a specific offering or two, and we will make arrangements for you to come up to our office and read the plans. We do not have a sufficient number to make distributions to the public, and we do not have facilities for their reproduction.

Now assume that you have been working on your condominium plan for some time now and have done a great deal of work and then your plan develops some problems which you want to discuss with someone. You may call my office and arrange a conference, but please do not come into my office and say, "I have a client who wants to form a condominium. What's it all about and how much do I charge him?" We will not tell you what to charge your client, and we will not tell you what it is all about. We *will* help you resolve a particular problem, provided you do your own homework. If you come in to see us with 95 percent of your work completed, we will try to help you with the remaining 5 percent. That does not mean that we are going to tell you precisely how to resolve problems. We will suggest alternative solutions and you will have to make your own choice.

The offering plan is a sponsor's offering plan. The Department of Law does not approve your plan; we merely determine whether you have fully and fairly disclosed the essential terms of the transaction in accordance with the requirements of law and the regulations of the transaction. Ours is a disclosure statute. We do not have a fairness or feasibility test.²² However, we *cannot* and *will not* accept for filing a plan which contains security-type fraudulent practices. I have already described to you the deceptions, the pretenses and all the other devices which the law says are fraudulent practices. Look at the plan from the same point of view as we would and make sure that all offensive material is eliminated. Tell your client that you don't think this or that is right and that the Attorney General will certainly be able to spot it and will refuse to accept it as part of the plan.

It is really a hopeless task to try to describe or analyze an offering plan in the time we have available today. I urge you to listen carefully

²² For a further discussion of the Attorney General's authority to reject offering plans, see Note, *New York Regulation of Condominiums*, *infra* at p. 964.

to the speakers as they point out various problems. You will find that any discussion we have here today — including how to form a condominium and what laws are applicable, the duties and responsibilities of the unit owners and the board of managers, the sponsor's obligations, the details with regard to construction, the requirement that three-dimensional plans show the dimensions of the condominium units, etc. — is applicable in one way or another to the offering plan itself.

You are far better off reading a plan and looking at the sections. I would advise you not to take the old plan verbatim and simply change the names, descriptions, and numbers. This is certainly not the way to do it. Every real estate transaction is different as you well know and you will find that merely copying somebody else's work means that you are copying his mistakes and compounding a few that he did not even think of himself. You are not improving on his work at all and you are not doing your client any service.

No particular form or method of printing is required for the plan itself. You may use the cheapest or most expensive, depending upon your client's pocketbook. The first submission must be in duplicate and may be typewritten or xeroxed, but must be black on white and clearly and distinctly lettered and easily readable. All basic documents must be included in duplicate and every plan that comes to us for original review must contain back-up documents.²³ We will comment on your plan and supporting documents. We will suggest revisions and clarification, and we will point out omissions and errors.

For new construction you must allow approximately two months from initial submission to final acceptance. For conversions of existing properties we will respond within fifteen days. This does not include the amount of time it may take in your office. The more complete your work is prior to submission, the more quickly your plan will be accepted for filing by our office.

Your big problem is in another area. Your client has spent a considerable amount of time in Florida and has given ear to some of the wildest rip-off schemes devised by the minds of man. Tell him to relax — he's going to have to make his money the hard way. Tell him that under New York law there is no such thing as a leasehold condominium or leasehold recreational facilities.²⁴ The sponsor cannot retain control

²³ The regulations provide for an optional prefilings conference. 13 N.Y.C.R.R. § 19.3 (1964).

²⁴ New York recently enacted a statute permitting leasehold condominiums for non-residential purposes. N.Y. SESS. LAWS [1974], ch. 1056, § 1(11) (McKinney).

of the board of managers for more than one year after transfer of the first unit and he cannot have a "sweetheart" management contract or any other stranglehold on the jugular veins of unit owners. Tell him that in New York there can be no expanding condominiums and that the sponsors cannot force upon new owners common charges in excess of their proportionate interest in the common elements. Common charges for incomplete or unsold units, to which title has not yet been transferred to a purchaser, must be paid by the sponsor in accordance with his percentage of common interest.

We live in an age of consumerism and the truth must be told in the advertisements as well as the basic documents which you prepare. You cannot entice a person into looking at a condominium by advising him that there will be an olympic-size swimming pool built when actually the pool will be 20' \times 40'. We really do not know what an olympic size pool is and so we demand dimensions. We demand that the advertising be consistent with the offering plan. If the offering plan contains no comment or information with regard to a particular fact, you cannot advertise it. For instance you cannot state in your advertisement that a condominium unit will cost the purchaser less to live in than a rental project down the road of the same size, shape and condition unless it's in the offering plan. There are certain words that you may use in advertisements which we call "puffing" — beautiful, nice, grand, etc. However, you cannot misrepresent size or construction. The standards are very simple — honesty in advertising as well as in your basic documents.

While you are working on your plan, your client has begun construction and has his finance arrangements worked out and is anxious to begin his marketing program. The Attorney General has issued Cooperative Policy Statement No. 1, which describes what we call "testing the market." It is designed to permit the sponsor to start his advertising program in a very limited fashion, and to receive non-binding reservations of \$50.00 for each of the units. This is not really intended as a pre-selling program at all; it is intended to test, for instance, whether three-bedroom units or two-bedroom units are in demand, whether your price is out of range, and whether or not your financing is an attractive picture because it goes into the question of how much the property will cost to maintain. The result of your testing should affect your work on the offering plan so that your prices and possibly your construction plans may be adjusted accordingly. Both the construction and permanent lender may condition a commitment upon the results of a testing under Cooperative Policy Statement No. 1.

One of the questions which constantly comes to our attention concerns the function of the attorney representing a buyer. An attorney should have the offering plan in his hands at least 48 hours before the client signs the contract. It is very burdensome to read an offering plan without compensation, whether or not the client buys the unit or whether or not you make a recommendation to him. I know many attorneys, who, after looking at the plan, have told their clients that this is the worst deal they could have gotten into because that is the safest possible answer. Should they not oppose the purchase, they would then have had the duty to read the offering plan and make a judgment. If attorneys are truly going to represent buyers, they must sit down and spend at least four hours in doing a thorough job of reading and understanding a condominium offering plan. We have not done your job for you by requiring the filing of an offering plan. It is up to attorneys to read the offering plan and supporting documents and explain to their client exactly what he is getting himself into.

Attorneys may come to the contract signing and suggest certain revisions and changes and the sponsor says, "Absolutely not. This is what the Attorney General insists upon." The sponsor or his selling agent is committing a fraudulent practice. The Attorney General does not insist on this particular deal. This is the deal that the sponsor proposes. The sponsor can change the deal if he wants to, but he must amend the offering plan. The reason is simply that the public should be advised of that change when it relates to potentially everyone, but there are certain areas where you should be able to negotiate a better deal. For instance, let us suppose that you have a closing date scheduled for September 1st and that your client is going to sell his building to somebody and he has to be out by September 1st. The question comes up as to what you do if the client cannot get into the new unit by September 1st. This is an area for negotiation and I leave to your fertile minds various ideas that occur to you that can be worked out and have been worked out in the past with sponsors. That kind of a change does not affect anyone else and carries no requirement for amending the plan. On the other hand, if the sponsor wants to offer that particular kind of a proposal across the board to everyone, that, of course, should be included in the plan by way of amendment.

A change in the bylaws or the declaration negotiated by the attorney for the buyer affects everyone. Therefore, it must be included in the amendment and if there have been sales prior thereto to individuals who have not been informed of the change in the declaration or

bylaws, their consent must be obtained if it is adverse to them. I might even say that it should be obtained in any event.

How are complaints handled in our Bureau? It is a very common problem for both buyers' and sellers' attorneys. The buyer's attorney should be aware of the fact that we will consider each and every complaint on its own merits. However, if your client is unhappy with the deal and wants out, that is not a complaint that we can consider seriously. That is the kind of problem he should have presented to you and taken your advice on before he bought his unit. When it comes to a problem as to completion dates, as to whether or not the representations contained in the offering plan are accurate or truthful, we will consider those complaints very seriously. We will in the first instance attempt to get the sponsor to make the necessary adjustments, and take the necessary steps to enforce his agreement. If we cannot get him to move voluntarily, we will take him into court pursuant to the powers we have under the Martin Act.

I would like to discuss in closing rule 10b-5 of the Securities Exchange Act.²⁵ There is no requirement that the ordinary residential condominium register with the SEC. The SEC has issued rules, however, that an investment type condominium, such as a rental pool or a similar device, must be registered because it is a security. However, some new developments occurred recently. On October 16, 1973, Justice Stewart of the Federal District Court for the Southern District of New York decided *1050 Tenants Corp. v. Jakobson*.²⁶ This case did not involve a condominium, but a cooperative. The court stated that although it appears to be an offering intended to provide housing for the purchaser of the stock of the owner corporation, it is subject to the provisions of rule 10b-5 because the purchaser intends or may intend to resell it at a profit and also because there are certain commercial spaces, which may be operated at a profit, thus reducing the common charges of the cooperative owners. I call this case to your attention for the single reason that the very language he uses with respect to co-operatives may also be applied as easily to condominiums. Under this case, federal jurisdiction exists over the sale of cooperative apartments by the use of deceptive practices, and purchasers may bring a class action against the sponsor for damages sustained as a result of such practices. This decision is a warning signal to condominium developers. Regardless of the future of condominiums, the trend throughout the country is toward legislation and practices such as we have in New York

²⁵ Rule 10b-5, 17 C.F.R. § 240.10b-5 (1970).

²⁶ 365 F. Supp. 1171 (S.D.N.Y. 1973), *aff'd*, Civil No. 74-1023 (2d Cir., July 8, 1974).

— full disclosure and extension of power of governmental agencies to supervise and police the selling practices of condominium sponsors.

PROFESSOR ROHAN: The SEC in the past several months has significantly changed its filing requirements. Now, instead of requiring a full-fledged 100-150 page filing, it will accept as little as a 20 page filing. Of course, this change does not prevent one from filing with the SEC a document as extensive as the Commission previously demanded.²⁷

ARTHUR LEVINE: Under New York law, there is no such option, so I would suggest that if you are going to register in New York, come to see us at the Attorney General's office first.

PROFESSOR ROHAN: In the supplement to the *Condominium Law and Practice* treatise there are examples of a full-fledged SEC filing²⁸ and a more modest 20-page filing,²⁹ both of which have been accepted.

QUESTION FROM THE FLOOR: Is there any difference in converting rent-controlled property to a condominium as opposed to a cooperative?

ARTHUR LEVINE: Not really. The very same problems exist for both. If you are going to attempt to evict any rent-controlled or rent-stabilized tenant in the city or elsewhere in the state, you are going to have to follow exactly the same procedure regardless of whether it is a cooperative or a condominium — the same percentage requirements and the same standard of non-discriminatory, non-fraudulent type offerings.

QUESTION FROM THE FLOOR: If you have a mixture of rent-controlled tenants and decontrolled tenants, does the 35 percent requirement relate to rent-controlled tenants or to tenants no matter what the type?

ARTHUR LEVINE: There are different rules for different buildings depending upon whether it is a mixture. A purely rent-controlled building requires 35 percent of all tenants in occupancy at date of presentation.³⁰ Assume that some of the apartments have become vacant and that some of them are under vacancy decontrol. The requirement still applies to 35 percent of the rent-controlled tenants then in occupancy, *i.e.*, at the time the plan is presented to them. This is distinguishable from the rent stabilization situation. The rent stabilization law requires consent of 35 percent of the tenants then in occupancy for a conversion, meaning in occupancy at the time the plan is declared

²⁷ See 1A ROHAN & RESKIN § 18.03, at 18-8.1.

²⁸ *Id.* § 18.07[1], at 18-53.

²⁹ *Id.* § 18.07[2], at 18-153.

³⁰ N.Y. CITY RENT REGULATIONS § 55(a)(3)(a) [cooperatives], § 55(f)(3)(b) [condominiums], enacted pursuant to NEW YORK, N.Y. LOCAL LAW NO. 20 (1962), placed the administration of rent control under New York city control.

effective, which may be as much as 18 months after presentation.³¹ The *Ortega v. Lefkowitz*³² case holds that you must have not only 35 percent of the rent-stabilized tenants in occupancy, but also 35 percent of the entire building.

PROFESSOR ROHAN: In this connection you should note that in several states there are bills in the legislative hopper currently that would require 35 percent or 51 percent of all tenants to agree to condominium conversion, whether their units are rent-controlled or not.

ARTHUR LEVINE: The requirement for 35 percent deals with the eviction situation. In 1965, in *DeMinicis v. 148 E. 83d St., Inc.*,³³ the Court of Appeals held that there is no 35 percent requirement for conversions to a cooperative, and we believe that applies likewise to condominiums. The only requirement is that if you want to evict any tenant for not purchasing, then you need the 35 percent. You can convert at 1, 5, or 15 percent. The only purpose and function of the 35 percent is to decide which of the tenants may be evicted. [Please note that subsequent to the Condominium Workshop the New York Legislature imposed a 35 percent approval requirement for all conversions, irrespective of whether the property is subject to rent control. — Ed.*]

QUESTION FROM THE FLOOR: Where the developer builds the new construction, is he obligated to pick up all or part of the common charges on the units that are unsold and/or under construction or can he shift the expense by contract to the unit owners?

ARTHUR LEVINE: We believe he must pay his share of the common charges. There is language in Article 9(b) which says in effect that he cannot waive his use and therefore his obligation to pay common charges³⁴ and we think that it violates the Condominium Act to require the purchaser of a unit to pay for that portion for which he has no occupancy and no ownership. Thus, under New York law, the sponsor,

³¹ N.Y. CITY ADMIN. CODE § 4451-6(c)(9) (1969).

³² 66 Misc. 2d 438, 321 N.Y.S.2d 17 (Sup. Ct. N.Y. County 1971), *aff'd*, 38 App. Div. 2d 792, 328 N.Y.S.2d 1008 (1st Dep't 1972) (mem.).

³³ 15 N.Y.2d 432, 209 N.E.2d 63, 261 N.Y.S.2d 1 (1965).

* On June 15, 1974, Governor Wilson signed into law a bill which requires 35% approval of all tenants in occupancy for any conversion of an apartment from rental status to either cooperative or condominium ownership. N.Y. SESS. LAWS [1974], ch. 1021 (McKinney). The new law applies statewide and is a precondition to any attempted conversion. To this extent, the law does not supersede existing local regulations relating to condominium and cooperative conversions since these regulations apply only to the question of eviction and not to the initial approval of conversion per se. Therefore, the results of the holding in *DeMinicis v. 148 E. 83d St., Inc.*, 15 N.Y.2d 432, 209 N.E.2d 63, 261 N.Y.S.2d 1 (1965), are specifically overruled by the statute. For a discussion of the new law see Note, *Tenant Protection in Condominium Conversions*, *infra*.

³⁴ N.Y. REAL PROP. LAW § 339-x (McKinney 1968).

the developer, and the builder of a condominium under construction must bear his share of the common charges.

QUESTION FROM THE FLOOR: May a developer advertise, test the market, take refundable binders, etc., without filing anything with the New York Attorney General's Office?

ARTHUR LEVINE: No. We have various forms and applications and I would suggest to you that before you do anything like that, get in touch with us and we will tell you about all the Cooperative Policy Statements in force. The theory is that under the law you cannot make an offering of a condominium or cooperative in the State of New York without first filing an offering plan with the Department of Law. We have waived the full filing requirement under certain circumstances but they are very limited in number and very rigidly controlled and we try to make sure that no buyer loses anything or places himself in a disadvantageous position in any way.

QUESTION FROM THE FLOOR: Are there any special requirements for filing for a commercial or industrial condominium?

ARTHUR LEVINE: The Condominium Regulations³⁵ state that we may accept the declaration of bylaws as a filing under section 352(e) of the General Business Law. I would suggest that anybody faced with the problem communicate with us directly and inquire whether in their particular case they are permitted to file merely a declaration of bylaws or whether more is required. The answer will depend upon your particular facts — the size, shape and number of units being offered. For instance, if it is merely a group of tenants — three or four tenants in a loft building getting together to convert the ownership of the building into condominium — we will treat it merely as a requirement to file a declaration of bylaws. If, on the other hand, it involves a large building where there are many, many tenants who will be asked to make a purchase of a condominium unit, we will take a totally different stance. Therefore, write to us and give us the details of what you propose to do.

QUESTION FROM THE FLOOR: In a four or six unit family conversion, can you get by on mimeograph paper?

ARTHUR LEVINE: You can always get by on mimeograph paper, even if you want to sell the Croydon Hotel. As I said before, you are not required to print, you are required to inform, and plain white paper with dark print is all that is required if the print is readable. Now, I have seen many, many plans where, in order to save money, the print has come down to postage size. We have very bad eyesight in our

³⁵ 13 N.Y.C.R.R. § 19.2(b)(xliii) (1964).

office, and we will not be able to read that and give you our letter of acceptance in situations of that kind. *Please* make it easy to read — that is the standard.

QUESTION FROM THE FLOOR: Where can an interested person get a copy of all the various regulations?

ARTHUR LEVINE: Write to the Department of Law, State of New York, Bureau of Securities and Public Financing, 2 World Trade Center, New York, New York 10047, and you will get a complete packet of material. Incidentally, when you write, just ask for condominium forms.

PROFESSOR ROHAN: If you get caught short on a Saturday, the supplement of *Condominium Law and Practice* contains all the New York Attorney General's forms on condominiums, as well as cooperatives.

QUESTION FROM THE FLOOR: How many conversions of rental units to condominiums are pending before the Attorney General's Office?

ARTHUR LEVINE: If I knew, I could not tell you. However, it is a fact that in the field of conversions the movement is away from cooperatives to condominiums, and we have had a number of large conversions to condominiums just come through.

QUESTION FROM THE FLOOR: Is there any role for testing the market in a conversion situation?

ARTHUR LEVINE: Yes, there is. Most landlords have a feeling that they are going to have difficulty converting rental buildings to condominiums or cooperatives. A landlord would like to get the feel of sentiment, and the best way, I think, is testing the market procedure, which is a very simple one. He does not have to collect any money, but he can if he wishes collect up to \$50.00. He can circulate letters among the tenants after he has gained our approval on them and ask if they are interested in a cooperative or condominium plan. In the letter he can set forth his approximate cost per room, the approximate maintenance charge per room, and in that way get a reaction. Our past experience has been that the reaction will be pretty much adverse. Even where an owner gets a good reaction, he will find he can be misled by the time his plans are complete. By the time he comes out of our office, there will be totally different market conditions. In addition many people may have an insufficient amount of money to purchase their apartment and may be very strongly organized against the plan. There may be questions of eviction. In instances where there is no eviction there may be lesser opposition. Where there are evictions, there may be very substantial opposition so you have to be very careful in testing your market. Evaluate it properly and do not rely too much

upon it. I would strongly urge you to consider plans which do not call for evictions. Today, with large turnovers in buildings where the resident population is composed primarily of senior citizens, you can anticipate that over a normal period of time you will have complete vacancy decontrol and there will therefore be no need to evict anyone.

QUESTION FROM THE FLOOR: Do you need a complete set of condominium documents and/or unit prices before you can get permission to test the market?

ARTHUR LEVINE: No, that is not necessary. Ask for the forms. They are a very simple set of forms and I do not think it is required to have a complete set of documents. What we are looking for is bonafideness. Assume someone is driving down a road one Saturday afternoon, and sees a big sign saying "Property for Sale." He writes to the owner and offers to buy the property at a quoted price. The owner replies that he will do it if they can come to additional terms. The prospective buyer thereupon applies to the Attorney General's Office for permission to test the market. Permission will not be granted because his interest in the land is too ephemeral. On the other hand, if he has a contract to buy the land and is prepared to go ahead and make the necessary application for zoning and he has some financing, this would give it the appearance of bonafideness and we will grant the permission to test the market.

QUESTION FROM THE FLOOR: In converting a building to a condominium, you must furnish the Attorney General's Office with a three-year economic history of the building—what it costs to run it and what the income was. Suppose you are not able to put together a "clean" option. In other words, there has been sloppy bookkeeping while you owned the building and now you have trouble getting a CPA to certify exactly what the cost was. What do you do?

ARTHUR LEVINE: You have troubles. My suggestion to you is to have your client hold on to the building for three years and do a clean job. We have had situations where there have been foreclosures by mortgagees and resale on the open market to a promotor or investor and he comes to us and says, "Look, I can't even find the owner, and I obtained the property under a foreclosure. What do I do?" Regretfully, I have to say that you must wait three years and that is what they are presently doing.

PROFESSOR ROHAN: The next speaker is Thomas Fegan. Tom started with Equitable Legal Department in Chicago and was Chair-

man of the Chicago Bar Association Real Property Committee. He was also one of the participants in formulating the Illinois Condominium Act,³⁶ which is regarded as one of the best in the United States, and is now with the New York office of Equitable and has been actively engaged in the condominium field, making suggestions and regularly examining the legal aspects of mortgage loan applications in terms of construction lending.

THOMAS FEGAN: Professor Rohan has stated that I will discuss construction lending. However, I cannot separate Equitable's construction lending from Equitable's unit lending and development lending, so I will necessarily encroach somewhat upon some of the material of the other speakers in discussing some of the things that we are interested in both as a condominium unit lender and a condominium construction lender. It is interesting by way of background to know how Equitable got into the condominium field so early, since very few insurance companies did. At the time the condominium concept began receiving attention, about 1963 and 1964, our President, James F. Oates, Jr., was a Chicago lawyer. Mr. Oates was intrigued with this new development in real estate law, although real estate was not his field. He frequently discussed the condominium concept as a method for greatly expanding home ownership, but we at Equitable experienced difficulty in supporting the idea. We made commercial condominium loans in Puerto Rico and California, but at that time our residential mortgage loan plan required the assignment of an insurance policy as collateral security. Unless you become involved in a condominium development early, you will get few of the residential unit takeout loans because the developer generally wants a blanket takeout condominium commitment. The few developers whom we approached brushed us off with the statement that it was difficult enough to sell condominium units without limiting sales to insurable prospects, so we had to approach condominium unit borrowers individually. As a result, we had to examine a set of papers virtually every time we made a condominium unit loan. The requirement that the insurance policy be assigned as collateral security was removed in 1969 and Equitable is now actively engaged in the condominium field.

Our services now include loans to developers to buy property, put in subdivision improvements, and construct the building or buildings. We also extend blanket takeout commitments for unit loans. Some of the commercial-type condominium loans we have made are also worthy of mention. One was a ground floor store in a five-story condo-

³⁶ ILL. ANN. STAT. ch. 30 § 301 *et seq.* (1969).

minium building and all we took was the commercial unit because of the restrictions which then existed on residential loans. In another one we made individual loans on each of two floors in a garage building in San Juan, Puerto Rico. Each of the floors was a condominium unit and was leased to a commercial tenant. The upper five or six floors were all parking stalls and it was interesting that each parking stall was a condominium unit. I am unaware of how they got the assessor in Puerto Rico to assess each one of the stalls on an individual basis for tax purposes, but it was done. The three developers of the project, instead of selling the units, divided them among themselves as a method of distributing the profits on the project. A third example of our commercial condominium lending involved a condominium in the Chinese section of San Francisco. The first five floors of a 17-story building were commercial office space and a single condominium unit. We made one loan on the five-floor unit and made condominium unit loans on most of the apartments up above. This is the type of arrangement you encounter when you engage in condominium lending.

I am also somewhat familiar with what other large lenders are doing in the condominium field, and it is similar to what we are doing. As for other insurance lenders specifically, I cannot speak with authority about their operations, but I can tell you that they are vitally interested in condominium lending.

I will now briefly explain the type of information we require before we make a condominium loan. Generally we want an experienced developer with some creditworthiness, and we want the property to be in an area where the condominium units will sell well. As an illustration of the importance of location, we have an apartment complex in Indianapolis, Indiana, which was deeded to us by the mortgagor because he could not make the payments. Instead of having us foreclose, he simply walked away from it and said, "You can have it." It was not successful as an apartment building, and our first thought was to convert it to a condominium and sell the apartments off as condominium units. There are four buildings, containing 500 apartments. We were told that in Indianapolis it would be a mistake. Condominiums are not as yet accepted by the public in that city. If this property was in Florida or California, it would be the first thing we would do. So when we say that a project must be in an area where condominiums are acceptable, it is because we judge a market on that basis. The utilities and the amenities must compare favorably with rental projects. If a developer's costs are so high that the assessments are going to be so very large, it will be cheaper for a prospect to live in a rented apartment,

and we do not think that he will buy a condominium unit of a similar type. The condominium has to be an improvement over a rental unit in order to make it feasible as a sales item.

How do we determine the criteria that must be met before we accept a condominium loan application? Our loan organization is large and we have architects, engineers and appraisers on our own staff. If we have any questions about the engineering or appraisal features of a project, however, we may require an outside appraisal or engineering study to confirm the findings of our own staff. Most national financing institutions do not have this large a staff, and a developer has to assume the cost of engineering and appraisal expense of the lender. The lender considers it to be a proper expense to be paid by the applicant for the loan because all he is paying the lender is the current market rate for money.

I have some figures, prepared by the National Association of Home Builders, on the increasing volume of condominium construction.³⁷ Condominiums amounted to 11 percent of the new homes constructed in 1970, close to 30 percent last year, and may approach 50 percent this year. Furthermore, condominiums constitute 70 percent of apartment starts in the Miami area. There were 50,000 condominium units constructed in Florida in 1971 and 50,000 in 1972, and they expect an increase in 1973. They should be up to 50 percent of the multi-family building market in Chicago, compared to no more than 5 percent a few years ago.

When we got into the early stages of condominium financing, we encountered a great deal of skepticism, and this was generally the attitude of almost everyone in the institutional lending field. There was not too much objection to a planned unit where the homes were similar to residences, but it took a great deal of courage to agree to finance a high-rise condominium. There were many people in the mortgage financing business who criticized condominiums back in 1964-66 with statements such as, "Who would buy a condominium when they can rent?" and "The apartment dweller doesn't want to put down roots; he wants to be able to move." These people did not think it was a feasible idea in most large cities. But they were proven wrong. Another objection was whether the common area expenses could be effectively controlled. It was argued that since you are going to be financing many people who are on tight budgets, who had set up their monthly assessment expenses within their income, individual families would experience difficulty in making up the shortage if the

³⁷ Wall Street Journal, March 29, 1973, at 1, col. 5.

condominium project was not fully occupied or if unit owners were not all paying their assessments. Again, that has not happened. A further objection was that they would not resell, that there would be no secondary market for condominiums. This, too, has proven to be unfounded as most condominiums have sold for far in excess of the original purchase price.

As a result of all of these objections, however, when we approached high-rise condominium lending, we insisted upon appraising it as an apartment building, not as a condominium, so that if we had to foreclose during the course of construction, if it was unsuccessful as a condominium, we could rent the apartments and the rental would be adequate to cover debt service or repay our loan. Because of our experience with condominiums, we are not now doing that. We are appraising projects on the basis of the aggregate sales price of the units and that gives the developer substantially more mortgage money to build his units — 20 to 30 percent more as a matter of fact. In most cases a developer can now cover his entire cost of construction through mortgage borrowing. But that is not universally true. If we have an inexperienced developer or an area where we are not sure of the market, we will reduce the amount of the mortgage loan accordingly and require that he presell 51 percent of his units. If he does that, then we assume that the project will be successful.

Condominiums have not developed evenly throughout the country. We find that most of our loan applications are coming in from a very few states. It may be that we are not being approached in some of the other states, but Hawaii, California, Maryland, Illinois, North Carolina, South Carolina, Virginia and Connecticut are the principal sources of our applications for condominium loans.

In construction lending, one of the first problems we have is what to do with the condominium declaration. When do we permit it to go on record? We prefer that the condominium declaration go on record after the completion of the building. When executing the sales contracts, the applicant can be given a complete set of the documents which are eventually going to be recorded, but if possible they should be kept off the record at this point. We prefer this procedure because we want to be able to foreclose if we have to and take over the property without it being burdened with a condominium declaration. It gives us a little more leeway to dispose of it after we acquire it. In some states you cannot sell condominium units with the declaration being off the record and in those states, if we are satisfied with the project, we will join in the declaration and permit it to go on record. We are receiving

opinions from our local counsel in some of these states, such as California and Missouri, to the effect that if we join in the declaration and permit the developer to use the earnest money deposits in the course of construction the courts will hold that we participated with the developer in inducing the sale of these units and the use of the funds in the construction, and will not permit us to foreclose and obtain the benefit of the deposits that were used in construction and freeze out contract purchasers, despite the fact that legally we would have a first lien right and should be able to foreclose. We are facing up to this situation by making sure that there is always sufficient money in our mortgage loan accounts to complete the construction of the project, so that if anything happens, we can take it over and finish it as a condominium project. What do we do about those purchasers and their earnest money deposits? We haven't had the problem arise as yet. Legally we think we have a right to foreclose them out, but I am not sure whether we would want to, or be permitted to, enforce those rights.

Most of the mortgage money that was available in the early stages of condominium development came from savings and loan institutions. Some banks participated early, such as the Dime Savings Bank and several others, but the insurance companies were very slow to recognize condominiums as acceptable security for mortgage loans. I think you have to give credit to savings and loan institutions for their courage and foresight. That was during a period when projects were fairly small. You now have very large projects, and, fortunately, along with the development of large condominium projects came the rapid multiplication of real estate investment trusts, which have stimulated the activity on construction lending. A real estate investment trust is a creature of tax law and it was really instituted to allow the small investor to participate in real estate investments so that the larger concentration of funds could be used in the home market. Real estate investment trusts are interested in short term, high interest rate loans. While it sounds high, they have been charging the prime rate plus 3 or 4 percent. A developer can pay that over a short period of time, but he could not possibly pay it over a long period. If, for instance, he were developing an apartment building, he could not pay that interest rate on his long term loan. That is where developers have been getting a large part of their money and we have been issuing take-out unit commitments where developers have obtained that kind of expensive construction money. In Florida, we have been charging $8\frac{3}{4}$ to 9 percent. This exceeds what we can get in New York and it is one of the reasons why money has dried up in New York.

We have been making leasehold loans in Hawaii³⁸ notwithstanding the fact that there is considerable opposition to leasehold loans by most lenders. It is easy to see why. A leasehold is a right to occupy property based on a lease. If you make a loan on a leasehold and the lease is cancelled, you have a mortgage lien on nothing. In Hawaii, the leasing of property, rather than the sale of the fee has been traditional. The old estates have a great many restrictions on the way they hold their property. One of the common restrictions is that they cannot sell it. Leaseholds in Hawaii, however, have been very acceptable. The ground rent is reasonable. Usually it's 6 percent of the fair market value of the land. Over the course of time owners have developed, with the help of mortgage lenders, paragraphs that protect a leasehold lender. For instance, the lease of a condominium will provide a consent to a mortgage of the leasehold, usually to an institutional lender. It will provide for notice by the owner to a leasehold mortgagee of any default by the lessee. If it is a default that can be cured by the payment of money it must be paid and the default corrected within 30 days under most lease provisions. But if it is a default that requires other correction, the lease will allow at least 60 days to cure. If it requires possession to cure, the lease cannot be cancelled until a foreclosure action is completed, plus a reasonable time to cure the default. Owners have even gone so far as to provide that, notwithstanding all of the foregoing, if, for any reason, the lease is cancelled, the owner will enter into a new lease with the mortgage lender on the same terms, for the same rent and for the balance of the term.

There are two things we do not like in the Hawaiian leasehold situation. One is the fact that it is for a fairly short period of time — sometimes 51 years.³⁹ We have accepted such leases when we are the first lender. We usually make a 20 or 25 year loan and amortize the principal over the term of the loan. The loan is repaid in full during the first 20 or 25 years of the lease term. It will pose a problem for a new mortgage to a purchaser 20 or more years from now. Who will make a mortgage loan on the short remaining lease term on a condominium unit?

The other objection is that if a condominium is terminated be-

³⁸ The Hawaii enabling act expressly provides for condominium development on property held by lease. HAWAII REV. LAWS § 170A-2(r) (Supp. 1965). See also CAL. CIV. CODE § 783 (Supp. 1974); FLA. STAT. ANN. § 711.08(1) (Supp. 1974) (not less than a 98-year term); GA. CODE ANN. ch. 85-16B, §§ 85-1603b(f)(1), (m) (Supp. 1973); MINN. STAT. ANN. §§ 515.02(3), (14) (Supp. 1974) (not less than 50 years); MISS. CODE ANN. §§ 896-03(F), -04 (Supp. 1972).

³⁹ Hawaii imposes no minimum term of a lease for condominiums on leaseholds. Cf. note 40, *supra*.

cause of condemnation or fire, the ground lessor takes all of the money allocated to the ground, and we keep the land value out of the appraisal of the unit. This is fine, except that the ground lessor also takes a pro rata share of the award or the insurance funds allocated to each unit based on the ratio that the number of expired years of the lease bears to the number of years that remain in the lease term. Again, we have accepted such leases if we are a lender at the time the lease commences. I do not know who will make loans on such leaseholds twenty or thirty years from now.

The situation in Florida is entirely different. There, leaseholds are used to obtain the maximum possible profit out of the units, and the ground rent is excessive. Although not all leasehold projects in Florida have been bad, as a matter of principle we have refused to make leasehold loans there.

In Hawaii they have introduced a bill which will permit the state to condemn the fees underlying leasehold condominiums.⁴⁰ The constitutionality of this practice has been questioned,⁴¹ but a similar law is now in effect for individual homes on leased fees.⁴² The pending bill starts out with a provision to the effect that a prime goal of the United States is the promotion of the public welfare and the securing of liberty, as enunciated in the Constitution, through the attainment of fee simple ownership of homes by the greatest number of people, and cites article 1, section 2 of the Hawaii constitution.⁴³ That's stretching the Constitution somewhat. The act, if passed, will permit 60 percent of the condominium owners to petition the state to condemn the fee and permit the leasehold unit owners to purchase at the then appraised value of the fee. In appraising the fee they will only consider the *then* income from the lease — *not* the discounted value of the future rents to be paid, which would be a normal part of an appraisal of a fee subject to a lease.

We examine every set of condominium documents before we make a loan. When we started condominium lending, the lenders were considered the experts on condominium documents. I assume this was because most of the articles on condominiums were written either by attorneys for title companies or insurance companies. In the early

⁴⁰ Hawaii H.B. 295 (1971 Sess.).

⁴¹ See Conahan, *Hawaii Land Reform Act*, 6 HAWAII B.J. 31 (1972).

⁴² HAWAII REV. STAT., ch. 516 (part 2) (1969).

⁴³ HAWAII CONST. art. I, § 2 (1959) states:

All persons are free by nature and are equal in their inherent and inalienable rights. Among these rights are the enjoyment of life, liberty and the pursuit of happiness and the acquiring and possessing of property. These rights cannot endure unless the people recognize their corresponding obligations and responsibilities. (Emphasis added.)

years most attorneys drafting condominium documents started with an FHA form and went on from there. When we received drafts of proposed condominium declarations, we had to make extensive changes. That is no longer true. Law firms have developed expertise in condominium drafting and the documents are now usually drafted in an acceptable form. The developer does not want his documents changed by a lender unless the lender insists and gives a satisfactory reason for doing so. We still find some objectional features in the condominium documents that we receive. For example, they must be fair to the purchaser. We have taken the position that we will not make loans on documents that take an unfair advantage of the purchaser. We began to refer to some of these projects that we encountered as manors. This was a reference to manors in the medieval English tradition. The developer considers himself as being similar to the "lord of the manor." He permits the peasants to live in his manor by buying condominium units. He not only keeps a long-term management agreement but he also retains the fee title to the recreational area and leases it to the condominium association on a long-term net lease at a high rental. He appoints the first board of directors for the association, and he keeps control of the association by either having loaded voting in his favor or by having two classes of stock with only the stock the developer owns being entitled to vote for a lengthy period of time. Thus, these people are really buying into something that they have nothing whatsoever to say about. We have objected to this and have declined loan applications. In some cases where the developer is desperate for financing we can convince him to change the documents to make them more palatable.

Just a word about the Florida recreational lease. That seems to be the one document that receives most of the criticism. The procedure is approximately as follows: the developer will spend about \$100,000 on recreational elements which he constructs on a tract to which he retains title. He will put in a swimming pool and some tennis courts, perhaps even a clubhouse. Then he will lease the area to the unit owners or to the association. Actually, when he creates the lease, it is with his own corporation as lessor and the condominium association as lessee, and since he appoints the directors of the association, it is a lease with himself. The lease will be for 99 years, totally net, and it may be for approximately \$50,000 a year. The purchasers of the condominium units are obligated to maintain the facilities for the entire 99 years. I think that Florida is going to have to do something about that particular form of abuse.⁴⁴

⁴⁴ Since Jan. 1, 1971, the Florida Condominium Act has provided that 75% of the

Management contracts were also a problem in Florida. The original management contracts we saw were for 10 or 15 years and they were burdensome, very high fee contracts. Florida has passed an amendment to the Condominium Act⁴⁵ that permits any original management contract to be cancelled at any time subsequent to the time the individual unit owners assume control by a vote of not less than 75 percent of the owners. In a multi-phase project, however, it is not subject to cancellation until the last association in the entire project comes under control of the individual owners.⁴⁶ If any of the completed condominium phases wants to cancel it as to their building, they can do so. They cannot, however, affect the condominium management contract on the recreational elements until such time as all of the phases have been completed. There is a recent case in Florida⁴⁷ involving a long-term contract that was entered into before this amendment became effective, and the Florida court has upheld its validity on the basis that the unit owners were aware that it was in effect when they bought their units. A committee appointed by the legislature in Florida is now considering an almost complete revision of the Florida unit ownership act.⁴⁸ Most of the abuses complained about will be taken care of in the new act.⁴⁹

In construction lending, we usually insist that the loan funds be dispersed through a title company. We want a clear title report before we start. We want each advance to be made after our own inspector has visited the property and has checked on the incorporation of labor and material into the project and has authorized the advance. We put the burden on the title company dispersing the advances to be in the position to issue a mortgage policy with endorsements covering each advance to protect us against mechanic's liens. We also require that not only the contractor but our own inspector certify that the amount remaining in our loan is adequate to meet the anticipated expenses

owners may cancel leases after they assume voting control. FLA. STAT. ANN. § 711.13 (1970).

The Internal Revenue Service currently discourages such practices in Florida by considering so much of the future rents as is above a reasonable rate of investment return (say 10% of cost) as part of the sales price of the unit and therefore taxable to the developer in a gross sum in the year the unit is sold. See 1 ROHAN & RESKIN, § 15A.04 (1974); Emanuel, *Condominium Developers and the Internal Revenue Service—The Florida Story*, 2 REAL ESTATE L.J. 760, 761 (1974).

⁴⁵ FLA. STAT. ANN. § 711.13(4) (Supp. 1974).

⁴⁶ *Id.*

⁴⁷ Point East Management Corp. v. Point East One Condominium Corp., Inc., 282 So. 2d 628 (Fla. 1973), *cert. denied*, 415 U.S. 921 (1974).

⁴⁸ FLA. STAT. ANN. § 711.01 *et seq.* (1969).

⁴⁹ See Amended Report of the Florida Condominium Commission to the 1973 Session of the Florida State Legislature, Feb. 15, 1973 (2d printing March 1973).

which will be incurred in the completion of the project. Construction lending is not much different from ordinary mortgage lending. We have a building loan agreement with the developer and in the event of a default under either the building loan agreement or the mortgage, we can move in and take over. We have an agreement with the contractor that if we do take over, he will complete the contract according to the terms to which he agreed with the developer, so that we are not faced with new or different construction costs. We are prepared to do that, but we have not yet had to. I believe that our careful evaluation of a loan application is the ounce of prevention that keeps us out of trouble.

We should spend some time on phase or stage condominium developments. We have had difficulty in Florida with two different legal opinions on stage developments, and the argument gets back to fundamental law. We have one group of attorneys who say that if in phase 1 you convey to a unit purchaser his unit plus a 2 percent undivided interest in the common elements, you have vested him with the fee title to the common elements, so that you cannot, even if you notify him in advance, come along with a second stage of substantially the same size and say that when we add this to the condominium development, he does not then have a 2 percent interest in the common elements but 1 percent, *i.e.*, 1 percent of an area twice as large.⁵⁰ These attorneys argue that you need a deed from each of the initial purchasers in order to divest them of 1 percent of their interest in the initial common elements in phase 1 in order to vest that 1 percent in the owners of phase 2. The other side of the argument, as presented by other attorneys in Florida, is that if, in your initial documents, you indicate the parameters of your development, *i.e.*, the number of units you are going to have, the number of stages you are going to have, the time within which additional stages will be added, and what each unit owner's percentage of ownership in the common elements will be after the addition of each stage, there should be no objection either legally or from a practical standpoint.

We have constructed two of our own condominiums in Florida with a developer as a partner. The first was a two-stage project and we used the approach of a complete illustration in selling the units in stage one, showing what the unit purchasers obtained in stage one and the change that would occur when stage two was added. We have obtained on the takeout loans mortgage policies that make no exception

⁵⁰ For a more detailed discussion of the concept of expandable condominiums and phased growth, see Note, *Phasing Condominiums, infra*.

as to the manner in which the percentage interests in the common elements was allocated. We are finding that in financing these stage developments, the common recreational and street elements are frequently being put either in a trust for the benefit of the initial as well as all of the additional unit purchasers, or the developers are creating a corporation, either with or without stock, to hold title. In one case we had five stages with 40 units in each stage. The corporation was created and issued 200 shares. The developer gave the first forty shares to the first association, to be held as common elements for the benefit of the 40 unit owners. The association will hold the stock. The balance of the 160 shares were delivered to a trustee, a bank, with instructions that as each stage was developed, and finished, an additional 40 shares were to be delivered to the association for the second stage, and so on through the five stages. If at any time the developer failed to complete a stage and there was a deadline on the completion of all stages, the undelivered stock was to be returned to the corporation. The initial association stockholders for the completed stages would be the only holders of stock having an interest in those common elements. I do not know whether that is a good approach or not, but we do not object to it — and it might be a solution to the argument about vesting and divesting of fee title. In the project I have just described, we required the developer to obtain a “no-action” letter from the SEC to ensure that we would not violate SEC requirements.

The Illinois Condominium Property Act⁶¹ was referred to by Professor Rohan as being one of the better condominium acts. Actually we have experienced more criticism about the Illinois Act than any other because of the way it handled the lien of assessments. I was on the committee which drafted the Illinois Act, and we had a very bitter dispute in this committee over how the lien of these assessments should be established. Chicago went through a very rough period during the Depression of the 1930's with cooperative apartment owners being foreclosed out of their apartments even though they were solvent and could pay their own share of the assessments. They just could not make up the deficit created by the number of owners who went broke and were unable to keep up their share of the assessments. There were taxes and heating costs and mortgage costs and the solvent owners just could not pay the overhead. The attorneys who had represented these people took the position that if condominium ownership was to provide the answer to the problem that co-ops created, then each individual unit owner should be absolutely independent of his neighbors, not only

61 ILL. ANN. STAT. ch. 30, § 301 *et seq.* (1969).

for taxes and his own mortgage but also for assessments. They established that since most units would be financed, and since most lenders had plenty of money, the place to put the burden of unpaid assessments was on the mortgage lender. As fair and just as that may seem to be, we of the opposition thought that it was not fair and just, and that it violated the investment statutes regulating most insurance lenders. The insurance investment statute in New York, for example, requires that the mortgage securing an investment be a first lien and that there be no condition under which such lien can be cut off or subordinated or otherwise disturbed.⁵² We wanted to present the proposed condominium act to the Illinois legislature in 1963 and we had a deadline, so we finally compromised by providing that unless the declaration provided otherwise the association could notify a mortgagee of a unit that there was a default by the borrower in the payment of assessments and for a period of 90 days after such notice unpaid assessments would be a lien that would prime the first mortgage.⁵³ I have had trouble with my own company on that score, because William K. Kerr, an associate of mine at the time and a condominium expert, leaned toward a strict interpretation of the New York investment statute and insisted that a mortgage on a condominium unit subject to such a provision violated the statute. However, I convinced our general counsel that it did not amount to much, that it was in the nature of a tax and that it could not grow to any great size without our knowing about it. If we were advised that it was there, as the Illinois Act requires,⁵⁴ we could bring pressure to bear on our mortgagor that if he did not cure the default, we could pay the assessment, add it to the debt, and foreclose if necessary. I finally obtained approval of this procedure from Equitable for condominium mortgage lending in Illinois. Wherever we can, however, if we are into the project early enough, we have the declaration provide that the lien for unpaid assessments will be subordinated to a first mortgage in order to take advantage of the provision in the statute. There has been some criticism of this aspect of the Illinois Condominium Act, and I just want to make clear that it was a compromise arrived at to settle a very bitter committee dispute.

One of the things we are concerned with now is the activity of the environmentalists. There is a case in California, *Friends of Mammoth v. Board of Supervisors*,⁵⁵ which is interesting, although the statutory

⁵² N.Y. INS. LAW § 81(6) (McKinney 1966).

⁵³ ILL. STAT. ANN. ch. 30, § 309 (Smith-Hurd 1969).

⁵⁴ *Id.*

⁵⁵ 8 Cal. 3d 247, 502 P.2d 1049, 104 Cal. Rptr. 761 (1972).

problem involved has been taken care of by an amendment.⁵⁶ A permit was issued for a condominium and the environmentalists brought an action to set the permit aside on the basis that the developer had not complied with the California statute requiring an environmental report.⁵⁷ The court stretched the terms of the Act to include a private construction project. The Act was very clear. It required governmental agencies, in projects of their own, to prepare an environmental impact report.⁵⁸ This was not done for the condominium project because the developer did not think that it was required. The court held that an environmental report must be prepared before the project could continue. In any event, California has amended the statute and an environmental report is now required even though the project is that of a private developer.⁵⁹

Recently, we purchased with several partners about 500 acres of land for a planned unit development in Palm Desert, California. We went to the Planning Commission of the county in which the property is located and pointed out that the statute required that the Commission prepare an environmental report. They said they did not know what an environmental report should contain and had neither the facilities nor the money to prepare it. They told us to do it. So we employed an engineer and spent \$5,000 preparing an environmental impact report. There are no standards provided by the statute, which simply states that the report is to measure the impact of the project on the environment. Every project that you develop has some impact on the environment. You must measure the good that is being done against the harm and make a subjective evaluation. Equitable has constructed guidelines to be followed as a matter of policy in lending construction

⁵⁶ See note 59 *infra*.

⁵⁷ See generally Environmental Quality Act, CAL. PUB. RESOURCES CODE § 21000 *et seq.* (Supp. 1974).

⁵⁸ The section formerly read in pertinent part:

All other local governmental agencies shall make an environmental impact report on any project they intend to carry out which may have a significant effect on the environment and shall submit it to the appropriate local planning agency

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CAL. PUB. RESOURCES CODE § 21151 (1971) (emphasis added).

⁵⁹ The California legislature has resolved the controversy explicit in *Mammoth* by amending the act. Section 21151 now reads:

All local agencies shall prepare . . . and certify the completion of an environmental impact report on any project they intend to carry out or approve which may have a significant effect on the environment.

A section was added to define "project" as including "[a]ctivities involving the issuance to a person or a lease, permit, license, certificate, or other entitlement for use by one or more public agencies." CAL. PUB. RESOURCES CODE § 21065(c) (Supp. 1974). The legislature further defined "person" as including private individuals or organizations. CAL. PUB. RESOURCES CODE § 21066 (Supp. 1974).

funds for new projects. You will find that most large lenders will adopt similar statements of policy. If you are interested in funds for a new project — not necessarily for a condominium, but any large project — be prepared to satisfy the mortgage lender as to the impact of your project on the environment. The following is an approximate statement of Equitable's policy: As a mutual life insurance company, the Equitable is a public service institution engaged in providing financial security for individuals and their families. In carrying out this function, we are entrusted with substantial sums which we are obligated to invest for the benefit of our policy owners so as to produce an optimum rate of return consistent with considerations of investment quality. Since some of our investments may have environmental impact we strive in our investment decisions to seek a rational balance between the economic and social factors which may be involved. The state of knowledge concerning environmental factors that are measured is still far from adequate so that such a balance cannot be determined with precision at present. A large element of judgment is necessarily involved in the evaluation process.

The procedures we apply are as follows: Each new investment is subjected to an examination of its environmental aspects monitored by an officer of the company. The investment is judged as to its environmental consequences, taking into account positive and negative factors insofar as they are determined. Only investments which pass such judgment as to rational balance are approved. With respect to existing investments where environmental problems develop, we will communicate our concern to our investment client or clients and cooperate to help overcome the problems. This policy reflects Equitable's desire to contribute to the nation's social and ecological well-being. We have been following through on this policy thoroughly. Our appraisers must cover affirmatively what they consider the impact of each project on facilities, sewage, water and air. We do not have many air problems with condominium developments, but we do have it with commercial and industrial developments. In any case, however, the project must be considered from an environmental impact standpoint.

I will just touch briefly on the Interstate Land Sales Full Disclosure Act.⁶⁰ We have taken the position in our condominium lending that the Act does not apply to residential condominiums in which Equitable is interested for mortgage loan investment. We are not issuing commitments for takeout unit loans that would take more than two years to deliver. Normally condominium sale contracts are not entered

⁶⁰ 15 U.S.C. § 1701 *et seq.* (1970).

into beyond two years prior to delivery. Most purchasers will not enter into contracts of that kind. Most condominium sale contracts involving new construction have a *force majeure* provision which excuses delivery of possession for the period of time that delay in construction occurs beyond the control of the developer. Whether or not the existence of this provision violates the two-year limitation period, I do not know. We have assumed that it does not. If we get involved in a construction delay that is going to continue beyond two years, we will simply have to contact Washington to see what their reaction will be. The exception in the Act that we apply to condominium construction reads this way: "The sale or lease of any improved land on which there is a residential, commercial or industrial building, or to the sale or lease of land under a contract [obligates] the seller to erect such a building thereon within a period of two years."⁶¹

There was mention previously of conversions of existing apartment buildings to condominiums. I will not spend any time on it because we have not, as a lender, been interested in making loans on conversion units. We have not done so because of the problems of maintenance and upkeep of older buildings and the lack of the amenities of a new development. When buildings are 20 or 25 years old we assume that they are going to have plumbing problems, roof problems and all sorts of other problems. I suppose you could compensate for this situation by making 50 or 66⅔ percent loans instead of 75 percent loans, but we also think that the unit owners may have large assessment problems. Alabama has just passed an amendment to its Condominium Act which permits some or all of the owners in a condominium project to enter into a blanket mortgage.⁶² I believe the purpose is to take care of this sort of thing by permitting owners to obtain mortgage financing for large repairs and renovation. The blanket mortgage is permitted only if there is provision for each unit owner to pay his proportionate share of the debt and thereby obtain a release of the lien from his unit so that it does not interfere with the sale of his unit and does not present a situation where he can be foreclosed out of his unit because his neighbors are not paying their share of the mortgage.

This preserves one of the basic attractions of condominiums — to isolate the unit owner from the misfortunes of his neighbor. The only exception, of course, is the possibility of the non-payment of assessments

⁶¹ 15 U.S.C. § 1702(a)(3) (1970). For a HUD release clarifying whether an exemption applies to condominiums, see 39 Fed. Reg. 7824 (1974). See also Note, *Consumer Protection and the Interstate Land Sales Full Disclosure Act*, *infra*.

⁶² ALABAMA LAWS ch. 1059 (1973).

by a substantial number of unit owners in the same project, and so far that has not become a problem for mortgage lenders. Our mortgages run for 20 and 25 years and, as I mentioned, they are amortizing mortgages. As the years pass the balance of the unpaid principal becomes substantially less as they amortize fully in the period of the loan. We do not think that the amount of a loan at a time when major repairs are required will be so great that it will represent a problem to us as a lender.

The problems raised by SEC regulations have already been covered by other panel members. The only thing that I would add is that as far as a lender is concerned, we can examine all the condominium documentation and determine that no SEC problems are created by such documentation, but we have no effective way of controlling verbal statements made by the salesman or the developer or even the advertising. At the present time we are not requiring that advertising be submitted to us or that it be subjected to our approval. We talk to the developer about his advertising and we tell him what our problem is and suggest that he talk to his attorney about what his problems will be if he violates SEC regulations.

Another thing to be aware of is the fact that condominium acts are constantly being amended. The latest amendments should be reviewed before you start working on a condominium in any state. We subscribe to a legislative service and get copies of the bills that are introduced in the legislatures of all of the states, and we also are advised when they become law. Many of the acts that are proposed are valueless. I received copies of eight proposed acts from Illinois in one delivery. One of them provided that in conversions, 25 percent of the units must be kept as rental units for income for the condominium. Now that could get the condominium into all sorts of problems.⁶³ Fortunately, only the better proposed amendments are usually approved and passed by the legislatures.

There is one additional thing that I might mention on the subject of the SEC. If you have a condominium that is subject to an SEC registration, the units can only be sold by a registered securities salesman. It will be a rare case where you have a real estate broker who is also a qualified securities salesman so you have to be careful in that situation. A word about condominium mortgage forms might be help-

⁶³ A question would arise as to whether such an offering might be considered a security investment subject to regulatory laws. Cf. 1050 Tenants Corp. v. Jakobson, 365 F. Supp. 1171 (S.D.N.Y. 1973), *aff'd*, Civil No. 74-1023 (2d Cir., July 8, 1974), (where cooperative which received income from rental of units as professional apartments was considered a security investment).

ful. Equitable's mortgage form may not satisfy all of you if you are looking for something that ties up the unit owner completely. It doesn't do that. Many of the savings and loan forms take an assignment of the right of the unit owner to vote and can exercise the unit owner's voting rights in the event of default and have other provisions of that kind. A good many of them require receipts every time an assessment is paid or require a deposit for taxes and insurance. We do not want any of those rights. We want to put an investment in our portfolio and forget about it unless there is a default. Unless there are some questions, I have completed my discussion.

QUESTION FROM THE FLOOR: When a developer's mortgage application goes to Equitable for construction funding or to any major insurance company, must it be accompanied by a market study?

THOMAS FEGAN: Not necessarily. We have our own field force, and we know what the market is in the cities in which we operate. If we have any questions about marketability of a project, we will require what we call a feasibility study, which is usually prepared by our own people.

QUESTION FROM THE FLOOR: Are the applications for condominium mortgage financing fairly standardized?

THOMAS FEGAN: In looking for funds, developers present us with all sorts of applications with varying approaches. Some want a construction loan and are willing to pay interest of 13 or 14 percent. Some of them do not want to incur such a high interest expense and are willing to give the lender a piece of the profit if the lender will give them a lower interest rate. We have run into a number of these. We will lower our interest rate provided we collect a percentage of the profit on the project. We have others — experienced builders — who want to be partners with us on the basis that they will supply the skill, the expertise and the supervision, if we supply all the money. We were initially reluctant to start projects on that basis, but we did participate in a Key Biscayne venture of this type. It involved construction of two towers containing 538 apartment units. The construction costs ran to about \$30,000,000 plus the cost of the land. We spent \$500,000 on a feasibility study which Equitable advanced and which would have gone down the drain if the study had indicated that the project would not have been successful. However, it did turn out to be a satisfactory project. We are splitting the profit 50-50 with our partner on this venture, and we are both making money on it. His attitude is that Equitable is in the business of investing money in construction projects, and he does not want to risk his money, but he is willing to devote his

time and his expertise to put projects together. You may question whether a 50-50 split of profit is fair either to him or us, depending upon which side of the joint venture you are on, but I would guess that our partner in Key Biscayne probably made \$1,000,000 a year for the last three years. That is what his 50 percent will amount to. But on the other hand, we cannot complain — so did we. We started out with the first tower containing 259 units and prices ranged from \$36,000 to \$90,000. The second tower was exactly the same but the prices ran from \$45,000 to about \$96,000. It did not cost any more to build the second tower, but that was the market price for the units at the time of sale. We sold out the units in the first tower long before we finished the first tower, and the same occurred with the second tower. There were people who offered to buy units from the original purchasers for more than the original purchase price.

We have a second partnership project with the same developer on Collins Avenue in Miami Beach. When it came in we thought it was a little too expensive for us. If you are familiar with Miami Beach, the property is right across from the Playboy Club, on the canal or west side of Collins Avenue. It is a high rise apartment building and the 84 apartment units start at about \$130,000 and run to penthouses at \$340,000. The largest loan we will make on any of them is \$75,000 because that is our maximum for residential loans. They are about one-third sold and the building is almost completed. It is expected that the units will be sold out before we are in a position to deliver them. I do not know where the people come from who have money like that. The developer had to do quite a bit of selling to convince us that that was a feasible project.

QUESTION FROM THE FLOOR: Why are New York City and New York State not on your list of areas where you have made condominium loans?

THOMAS FEGAN: We would be willing to make them but it is a question of investment return. There are some good condominiums in which we would be interested in Westchester, but they can get cheaper money from savings and loan associations in Westchester. They can get better interest rates from some of the banks than the rates we are willing to accept. We are a mutual insurance company, not a stock company. All of our investment return is for widows and orphans. We work very hard to obtain the highest interest return consistent with safety.

QUESTION FROM THE FLOOR: Assuming that you are not partners, and are just lending construction money at 14 percent, what is your

average pre-sale requirement before you advance any of the construction money? How many units must be under contract for sale before you start the construction lending?

THOMAS FEGAN: It depends entirely upon the area. In some areas we are so sure of what the condominium sales will be that we will disburse funds without the developer having sold any units. There are other areas where we want 51 percent of the units pre-sold or reserved as they say. Reservations are not very important where very low deposits are accepted. If anyone wants to withdraw they can within, I believe, 15 days after they receive a complete set of documents and they will obtain a refund of their deposit, so reservations are not very effective. If we are fairly sure of the area and satisfied with the kind of project we are financing we will not demand pre-sales.

PROFESSOR ROHAN: Our next speaker is William H. Parry, counsel to the Williamsburg Savings Bank.

WILLIAM PARRY: There are many theories on the origin and development of the condominium concept — some say it originated as far back as ancient Rome, where people lived in stories. The English flat has been with us for many years; the Franco-German concept has been in existence for years; Brazil now has a statute; so does Chile.⁶⁴ No one, however, calls it a condominium.

The word condominium is of Latin derivation and connotes joint control. A mini-democracy is created in which the air space and land is divided up horizontally and vertically. That is all we have done. We have taken land, and created cubes on and above that land, and divided it by planes, some of them curved, most of them straight, and we say, "Come and buy your little cube and we'll give you an undivided interest in the land that is underlying it." Many of the statutes are known as Horizontal Property Acts because the air space is divided horizontally. It is a form of ownership, and many states have not implemented the statutes with the establishment of such regulatory authority as we have here in New York. I think it is fair to say that New York probably has the toughest requirements. Trying to get these plans through the Attorney General's office is difficult. The people there are very nice to deal with and extremely capable, but their aim is to protect the public. You have heard enough about Florida, where the people have apparently not been protected as they have been in

⁶⁴ See, Note, *A Comparison of United States and Foreign Condominiums*, *infra*.

New York. It creates problems — for the developer, for the developer's lawyers, and for the lender's lawyers.

Most states enacted condominium statutes and enabling acts between the years 1962 and 1968. New York's first condominium legislation was Chapter 82 of the Laws of 1964.⁶⁵ It is now Article 9-B of the Real Property Law.⁶⁶ The unfortunate aspect of the law, from the viewpoint of the attorney representing an individual unit purchaser, is the offering plan the developer must prepare. It is normally quite large, and the attorney representing the purchaser of a unit, if he is going to do his job, *must* read this. He must analyze what is in here. You have to dissect it almost to the degree that the Attorney General's Office does because the plan contains not only mortgage terms and estimated tax payments, but also possible hidden costs, such as separate metering. Some condominiums are heated centrally; some are heated electrically with their own meters. If you are trying to advise a client as to whether he can afford to buy a particular unit, you must read the offering plan. In the offering plan there is, hopefully, a complete disclosure of how the units are to be constructed, the materials and the fixtures that are going with it. In the back you have three-dimensional pictures, showing the appearance and size of the units. You also have the declaration that will be filed, and the bylaws. An *extremely* important part of your services as an attorney to your client is to understand these bylaws in order to explain to him his rights and obligations under this mini-democracy.

I have a plan before me which grants to the first mortgagees — and, incidentally, in New York lenders can only take first mortgages⁶⁷ — the right to appoint one to three representatives who will act as a liaison to the board of managers. It restricts the board of managers in certain ways. For instance, the board of managers here can make expenditures for improvements or alterations of up to \$10,000 without a vote of the unit owners; anything above \$10,000 requires a vote of the unit owners and approval by the mortgagee's representatives. I do not think this is harsh, because I think that in the future we are going to be facing a problem in management. Realize that in this mini-democracy which we call a condominium there is a board of managers elected by the unit owners to run the entire operation. If these people are experts or even knowledgeable in the field of maintaining property of this scope, the unit owners are lucky. If they are not so expert, how-

⁶⁵ Ch. 82, [1964] N.Y. Laws, p. 91.

⁶⁶ N.Y. REAL PROP. LAW art. 9-B (McKinney 1968).

⁶⁷ *Id.* § 339-ff.

ever, they will have to seek expert advice and help. Generally, these plans authorize the board of managers to hire professional managers or a managing agent to take care of the day-to-day problems. Perhaps small condominiums do not require a professional manager. In large projects, however, my own view is that people would be crazy not to have expert management, particularly in the high rise type condominium. And, I think we are going to find that the problem of obsolescence, the problem of replacement, is going to be one of major concern to the unit owners. If they do not have expert management at their disposal to set up the proper reserves, to be sure that they are going to be able to repair and replace these particular buildings, twenty years from now they are going to face difficulties. So, we do have the problem of expert management. We are going to need more and more expert managers, and I do not think we have enough of them in the industry.

We are going to have problems with the mini-democracy. We have seen it in certain instances already where the board of managers wanted a basketball court, but somebody did not like the idea (and the expenditure of \$500) and so he sued. In the more magnificent condominiums, ones with golf courses, swimming pools and tennis courts, what happens when a group of people who have become enamored with tennis find the three or four courts no longer are adequate and want more courts built because they are not golfers? As in any society you are going to have blocks of people who want things done and blocks of people who do not want things done. The experiences of the future will tell whether these are real problems or are just things that we have conjured up and talk about in New York after only nine years of experience. There is little case law on condominiums. Most of our reasoning is by analogy to cases involving cooperatives, since we have had cooperatives for a much longer period of time. We have seen some of the problems that exist in cooperative management. We have seen some of the problems that exist among the stockholders in a cooperative corporation. I think that we can predict that things are not going to be completely rosy in the future in the condominium field. From a lender's viewpoint, this can present a lot of problems.

Now, we are somewhat protected in New York if the unit owners decide they are going to dissolve this little democracy. The mortgagees and lienors will have to be paid before the unit owners get their money out if they petition and sell.⁶⁸ We do have problems, of course, where there are fire losses. There are statutory provisions in New York pro-

⁶⁸ *Id.* § 339-z.

viding that if 75 percent of the building is destroyed and at least 75 percent of the people do not *promptly* move to repair it, the property is subject to partition.⁶⁹ If the mortgage lender has loans on those units which have been burned out, you have got to look to the insurance recovery; so you must be sure that there is sufficient insurance to cover the investment. The statute provides that the board of managers may carry the master policy, if it is so stated in the declaration.⁷⁰ The statute does not *mandate* that this be done; it must be in the declaration. As lender's attorney you should insure that this provision is in the declaration and that the bylaws are strong enough to protect the lender in case of fire loss.

Assuming now that as purchaser's attorney you have done all of the analysis and have told your client to go ahead and buy, your closing is not unlike the one-family house type of closing. Present are going to be the title representative, the sponsor's attorney ready to convey the property, the mortgage lender's attorney if your client is financing the purchase, and you will make your adjustments. You will find set forth in the offering plan the closing costs that will have to be paid, the adjustments that will have to be made, and you go through it like you adjust on any one-family house. If you have done all your homework, you should have no problem closing it. You will find that in addition to all the other documentation, there is a power of attorney form. Most condominium plans provide for a right of first refusal for the board of managers. If the unit owner gets a bona fide offer from an outsider to purchase the unit, he must make that unit available to the board of managers at the same price, under the same terms. The purpose of the power of attorney is to give the board of managers the right to buy that unit provided everything is done properly under the terms of the bylaws, etc. Some people look upon this as a restriction on alienation, an attempt to keep out undesirables. Its effect may very well be that, but there is statutory authority that lends itself to an interpretation that the board of managers or the unit owners could do that.⁷¹ At the closing of the resale of a unit, the title company will require proof that the board of managers has waived that right by a showing of consent from the board of managers. You will also need an estoppel letter from the board of managers on unpaid common charges.⁷² Once they give you a certificate as to the amount of the unpaid common charges, you pay it and the transaction may proceed.

⁶⁹ *Id.* § 339-cc.

⁷⁰ *Id.* § 339-bb.

⁷¹ *Id.* § 339-v(2)(a).

⁷² *Id.* § 339-z (McKinney Supp. 1973).

Some of the problems we have had in the condominium area are concerned with the mortgage market. Most of you, particularly those from New York, are aware that the banking board, after public hearings in September, 1973, increased the maximum permitted rate to $8\frac{1}{2}$ percent. You will find that a lot of the condominium plans provide that mortgages will be at the maximum rate permitted by New York law at the time of the closing. This has presented us with a number of problems. After the extraordinary legislative session, we went from $7\frac{1}{2}$ to 8 percent and now we are at $8\frac{1}{2}$ percent. Many of these commitments were outstanding at a time when the maximum rate was $7\frac{1}{2}$ percent. People now find themselves paying 1 percent more interest, which is rather sizable. For example, the $7\frac{1}{2}$ percent rate on a 30-year mortgage was \$7.00 per \$1,000 so that on a \$20,000 mortgage payment of interest and principal would be \$140.00 a month. At 8 percent on a 30-year mortgage, it increased to \$7.34, and at $8\frac{1}{2}$ percent it jumped to \$7.69. So you can see how the monthly payments have increased, and when dealing with people who are on margin, your credit officers have had to re-evaluate to be certain that these people can handle that level of monthly payment. With the increasing inflationary spiral, the operating costs in any project are rising, and thus common charges will naturally increase in the future. From your client's viewpoint, purchasing a condominium is somewhat of a gamble as to whether his income in the future will be able to handle it.

It was not so long ago that this great phenomenon, the demand for condominiums, swept Long Island to the point where the rental units were going begging. Many of the big operating developers there had their original experience in one-family house development. They have been able to translate that experience into condominium development, and they are getting bigger and more magnificent because competition is forcing them into it. The golfdominium and the waterfront condominiums, which are being developed with slips for boats, give the impression that in order to compete you must be very imaginative. There is one development that does not have a superintendent or a managing agent, but rather a concierge. This is obviously a marketing technique, and there is a need for such techniques in this competitive field, but within the framework of disclosure, such advertising is a very serious concern to the Attorney General's Office. However, I think that most of the builders with whom we are dealing realize what they are getting into and are playing the game because they are too big to fool around. They cannot afford to lose the reputation it took them 20 to 25 years to build by fooling around with an advertising scheme.

The mortgage market for condominiums right now is obviously tight because of the $8\frac{1}{2}$ percent limitation on individual mortgages. The question of usury relating to yield on both construction and unit financing is very gray at this stage. You will recall that back in 1968, the Legislature of New York broke the line that was rather sacrosanct for so many years and increased, or at least created the mechanism for increasing, the interest rate above the 6 percent level. The device they used allowed the banking board to set the rate based upon economic factors between 5 and $7\frac{1}{2}$ percent. The banking board immediately set the rate at $7\frac{1}{4}$ percent and very soon thereafter increased it to $7\frac{1}{2}$ percent, and we were locked at that level. You are undoubtedly aware of what happened when the ceiling on interest rates was lifted and everybody had to jump into the market to try to retain what they had on deposit and in certain cases to make up for tremendous losses they suffered. The New York savings banks, alone, for the month of July, for instance, lost some \$270 million in deposits. Obviously, if they have to come up with that cash for their depositors to take their money elsewhere, they do not have the cash to invest, and so they become very selective in the types of lending they are going to do. Suddenly, you find that 90 percent loans are not available any more, only 75 percent loans with term restrictions and closer credit evaluation by credit offices. You even find some pulling right out of the market and telling the usual suppliers, the brokers and home buyers, "We're sorry; we are out." Jumping into the so-called "wild card" type of account, many banks found themselves now paying $7\frac{1}{2}$ or 8 percent to try to get that money back in or to hold it. If you add on top an operating factor you can figure a point. To entertain that kind of an account, paying 8 percent compounded daily and a point on top costs a fortune. So economically, the banks have been forced into restricting their lending here in New York.

Some people in New York claimed that the banks were staying out of the mortgage market just to give the superintendent the right to raise the rate of $8\frac{1}{2}$ percent, and possibly there was some legitimacy to that assertion. However, I do not think so because you are competing with a market outside the State of New York that makes lending extremely attractive. The reason that all of us — Williamsburgh, The Dime, Jamaica, Seaman's, etc. — get into this is that we have always been in the one-family housing type market. The savings banks and the savings and loan associations have traditionally been *that* type of lender in New York. We have not actually had to change our investment policies as so many other banks have had to and go into different types

of lending, such as investment in projects that formerly were within the almost exclusive jurisdiction of the insurance companies and the large commercial banks. We lend construction money; in fact, Williamsburgh's policy in lending is that it would rather have the entire package. Unlike the insurance companies, we like to tie up the construction money and the permanent loans in one package. We do not like to give just permanent loans on condominiums for a very good reason. We are lending the corporate sponsor the construction money at construction money rates so that, obviously, we are getting a nice yield or return on the money that is used by the sponsor to build his project. Then, of course, we are taking out permanent loans ourselves and giving them to individuals under the usury restrictions of General Part IV of the Banking Regulations⁷³ at $8\frac{1}{2}$ percent, with no points or anything of that type. General Part IV, by the way, contains the Banking Department's regulations on what exactly should be included in the interest calculation and those items that are not includible. I know the savings banks had a tough time with it in the beginning, but General Part IV is the bible, and that is the way we are lending.

We have run into more problems in the truth-in-lending area. When you put out truth-in-lending statements that show numbers that do not accord with fees and charges here in New York, people get the impression that you are pulling something on them. For instance, at the $7\frac{1}{2}$ percent rate we would show a $7\frac{1}{2}$ percent interest rate, but because of certain items, particularly in the FHA area, that had to be included in the annual percentage rate calculations, there were times when we would show a different annual percentage rate which is not an interest rate. Those of you who have been closing since the Truth in Lending Act⁷⁴ was enacted are aware of these things. A condominium unit is treated just like a one-family dwelling for closing purposes. We are lending to individuals, and right now we are charging $8\frac{1}{2}$ percent. There are certain areas in which we are holding the line on the old commitments and some people are getting the benefit of the old rate. This is done as a matter of policy. These were commitments made at the time of the extraordinary session, and the Superintendent of Banks has asked that we try to honor them where we can for public relations purposes. We have done that with a time cut-off, but I think that at the end of this year you will find that every one of our mortgages will be closing at the maximum rate. If a developer who has paid points to a bank tries to pass the points on to a purchaser, I think there would be

⁷³ § N.Y.C.R.R. § 4.1 (1973).

⁷⁴ 15 U.S.C. § 1601 *et seq.* (Supp. IV, 1968).

a problem under the regulations of the banking department as they now exist. It would probably be construed as payment made indirectly to the benefit of the borrower; it would have to be. Although we have no ruling from the Court of Appeals on it, it is my opinion that it would have to be included in the interest calculation. The question of what results when he takes a point and does not pass it on has not been resolved either. We are cautious and we just do not do it. If these are true purchase money mortgages, and you do take them back, I would be a little cautious and say that you have to season them in your own portfolio before you go out and peddle them because the courts may cut through the device you have used to avoid the operation of the usury statute. In the State of New York the tradition of the courts is to look for the substance and not the form of the transaction.

Another problem concerns the long-term financing of conversions. It is extremely difficult to get long-term financing for conversions. I do know of certain instances where it has been impossible through the normal channels of financing. It is extremely difficult to find an institutional lender who will finance a conversion because of the reluctance of our appraisers and engineers to try to make an evaluation that this is a completely sound structure and will remain sound for the future without increasing the tremendous operating costs of the individual owners. So, in keeping with our long-term investment policy, the Williamsburgh Savings Bank is committed to the construction field, and especially to the builders who have been with us for many, many years.

When a bank appraiser goes into a conversion type of operation, he is trying to project what the cost is going to be for the term of our mortgage. For instance, if we are having a conversion of 20 units, most people will apply for 30-year loans. Our appraisers try to project within that period of time. Of course, not all mortgages last 30 years; we have about a 12 year average. Within the time that we would generally be involved in financing that structure, the appraisers project what condition it will remain in and the cost to the unit owners to keep it in the condition we want. Now this leads me to one of the real problem areas—that of being locked into the financing. We have found that in every condominium development which our bank has financed, we are now wedded to that little democracy because banks are *extremely* reluctant to finance one or two units in a condominium. If a bank cannot be the big lead, it does not want it. We have found that the only source of financing on a resale has been the Williamsburgh Savings Bank. We feel that it is rather unfair of us to say to a party to

whom we gave a mortgage for 30 years and who must sell the house or the unit, "We're sorry; we gave you the money, but we're not going to give it to anybody else." Now he cannot sell because no one else is going to finance that unit, and so we find ourselves locked in there. This is something that we would not want to do in the older building.

ARTHUR LEVINE: This is a very serious problem area for the banks. I would like to point out to those who represent purchasers that this is something to alert your client about. It means that when your client goes to resell his unit he is going to have to go back to the very same bank, and there will be no competition regardless of the condition of the market and the availability of money. Hopefully, the banks may get together if documents become standardized so that the banks are not required to redo the entire plan from scratch. But at the moment that is not the case.

WILLIAM PARRY: If the bank is going to finance one unit, this means that the bank's attorney is going to have to make the same analysis that we might have done for a project of 500 units. So economically, it is feasible for us to do the study for a project of 200 to 400 units. It is not economically feasible for the bank's attorney to have to sit down and digest the disclosure documents and advise the bank whether it should get into the condominium for one unit. The bank is certainly not going to pay an attorney for doing this and the individual borrower certainly could not stand the bill that he might get for this. So you have a practical problem.

New York, by statute, requires that at the time of the first conveyance of a unit it must be relieved of the burden of any mortgage except its own.⁷⁵ Generally, when we get into the construction of a condominium project, we place the construction loan on the entire perimeter. Thus you have a tract of land that is the security for the construction loan and whatever improvements have been made to that tract. There are two approaches. When this is declared as a condominium, we break up the construction loan into units. So if you have 250 units to be built, we will break the basic blanket loan into 250 loans and attribute one to each of the units in its common interest. We provide in the original loan that we may substitute 250 separate mortgages, in the aggregate not more than the basic loan document itself. If we put a five-million-dollar building loan mortgage of record, we break that into 250 units and ascribe a certain dollar amount to each mortgage. When the time comes to close title of a unit and to close the individual mortgage on that, the people may want more. So we put an additional loan on a

⁷⁵ N.Y. REAL PROP. LAW § 339-r (McKinney 1968).

consolidated loan. There is also, however, the possibility of using the release method. If you release part of the mortgaged premises through the usual partial release, and cut that unit out of the blanket mortgage and put on a new mortgage, the problem is with the mortgage tax. The statute allows a proportionate exemption in the release situation.⁷⁶ They actually set up the formula right in the section, that the release is being granted and a new mortgage is being placed on it.⁷⁷ You do get a partial exemption of the mortgage tax attributable to the new mortgage. In the break-out situation at least one condominium is having difficulty right now with the county clerk, who is taking the position that once that was used in the break-out he is not going to allow it to be used for the new mortgage. Now, I do not think that this is a Condominium Act problem. I think that section 255 of the Tax Law⁷⁸ is the solution to this and we have always had that right. So, once you have broken it out, under case law at least, you can do that.⁷⁹ Once you have broken it into 250 pieces there is no mortgage tax payable on the break-out in my opinion under section 255. Then if you are passing it on to the ultimate purchaser, there is no tax payable. If you are putting an additional loan on, you should have to pay the mortgage tax on the additional amount. I think and hope that the question has finally been resolved.

PROFESSOR ROHAN: With respect to the subject of the horizontal property regime, title companies at the very least will require the developer to specify the number of units planned for the project. At the developer's discretion he may, for example, provide initially for 100 units, with two 100-unit stages to eventually follow. If he employs this staged growth approach, the developer should set out appropriate cut-off dates for the development of each stage. Title companies will also require that the developer exhibit little variation in the style and layout of the second and third sections. One of the difficulties in this area is the statutory command that the developer assign an undivided percentage interest to each unit from the outset. This significantly handicaps the developer who has not precisely fixed the number of units he wishes to construct. To satisfy most of the enabling legislation provisions, the developer should indicate the number of stages planned and the number of units per stage; therefore, the percentage interest will be determined by the final stage. The offering plans of the purchasers in the initial stage (or stages) should contain this information.

⁷⁶ *Id.* § 339-ee.

⁷⁷ *Id.*

⁷⁸ N.Y. TAX LAW § 255 (McKinney 1966).

⁷⁹ *People v. State Tax Comm'n*, 220 App. Div. 396, 221 N.Y.S. 646 (3d Dep't 1927).

Additionally, the developer should take back from the purchasers of the initial stage the power of attorney to go back and amend the declaration to reflect subsequent revisions in the undivided interest of any unit. In this connection, the Attorney General's Office in New York requires that although you have indicated in your schedule that you will notify that office by January 1st of this year whether you are going to build the second 100 units and then by January 1st of the following year whether you are going to build the third 100 units, you must make a final decision on everything before you actually close title to the first unit — not before you go to contract but before you close title. Is that right, Arthur?

ARTHUR LEVINE: Yes, basically that is our position. We have adopted the more conservative view of insisting on definiteness at the moment of closing of title of the first unit so that the problems that will be created by expanding a condominium after the deed has been issued would be avoided. Now, I know there are many people who criticize this rule.

PROFESSOR ROHAN: An alternative approach, of course, is to treat each section as a separate condominium. There is much to be said for this method, in that if it takes you a two-year lead-in time to build the first 100 units, you have that two year's market, cost, and inflation experience to assist in repricing and redesigning the entire second section. If you recall, Heritage Village located in Connecticut is now in about the twenty-third condominium. They have 23 of them knitted together with an overall association. Apparently this is the approach taken by most builders today. It gives them considerable flexibility, in that they can, at the outset, display attractive features of the development, such as recreational facilities, but still permit later purchasers to enjoy these privileges. In the case of recreational facilities this is done by putting the facilities in an umbrella association and stipulating that subsequent unit purchasers will be granted membership in it.

A second question pertains to whether or not you should select the condominium approach or the homeowners' association approach. If you choose the homeowners' association, you do avoid some of the problems associated with phasing in, because you do not function within statutory limitations. Another advantage of going the homeowner association route is that you can have a much smaller pre-sale requirement. If, for example, you have enough lots for 200 townhouses and some recreational facilities, should you opt for the condominium regime, the financing institution typically will say that before it provides construction money one-half of the units will have to be pre-

sold. But if the project is a planned unit development, the developer could break it down into much smaller segments, for example, 40 lots at a time. If a lending institution required one-half of the units to be pre-sold before it supplied financing, the builder would only have to sell 20 before commencing work on the entire 40.

Differences in treatment of the two types of regimes extend to government programs. The Federal Home Owner Association Program is an element of the Single Family Home Program, which is completely distinct from the Condominium Program.⁸⁰ However, there are disadvantages to the homeowners' association scheme. The FHA may require that each unit in a homeowners' association arrangement have separate utility services. And insurance carriers may impose more stringent requirements upon the homeowners' association unit.

In terms of federal financing the homeowners' association has an advantage. Many developers in the low income housing field say that units in the \$20,000-27,000 market are qualifying under the FHA. As a result, they can use the 95 percent financing available through the FHA program. On a \$25,000 sale, for example, the purchaser might have to put up only \$1,250 or less.

ARTHUR LEVINE: The homeowners' association is considered to be a cooperative interest in realty within the provisions of section 352 of the General Business Law,⁸¹ and there are requirements similar to those governing condominium offering plans. Please be aware of the requirements and of your obligation to provide a copy of an offering plan or your right to receive one. Anyone who is interested in filing such a plan should get in touch with our office. We have a suggested model form which will aid you greatly.

PROFESSOR ROHAN: In New York, if you are selling housing in conjunction with a homeowners' association even though there may be no condominium or co-op in it, the H.O.A. is treated as a cooperative offering in real estate. Another factor that should be noted in evaluating the use of the homeowners' association is that, theoretically, the association owning recreational facilities should incur the liability for the real estate tax associated with these facilities. Unfortunately, this results in a loss of an income tax deduction to the homeowner. In many of these projects, we have been able to negotiate with the assessor to have him either give no real estate tax bill to the H.O.A. or to give it a minor tax bill and assess the real value of the common

⁸⁰ 12 U.S.C. § 1715y (1970).

⁸¹ N.Y. GEN. BUS. LAW § 352 (McKinney 1968).

facilities back into the purchase price of the home, in order to permit the homeowner a tax deduction.

Another problem of converting property is securing capital gains. There have been a lot of articles floating around within the last few months on obtaining capital gain when you convert an apartment house to condominium status. All along there has been no question when you convert to co-op status, because you sell the building to a single cooperative housing corporation — it is one sale and you get capital gain even though eventually it will be resold, as it were, to 100 proprietary lessees. But if you go the condominium route, you may, for instance, be selling 100 fee titles, and therefore have 100 closings. Having sold more than five units, you would fall within the dealer status, thereby probably realizing ordinary income. One approach to this capital gains problem would be to take the property that you are going to condominiumize, transfer it into one of your other corporations that has losses or other deductions, and let that corporation convert the property to condominium. Even if you have ordinary income, it will be offset by the losses. Others have suggested deeding it out to a dummy corporation at the stepped-up price that you expect. For example, suppose you own a million dollar building — that is what you paid for it — and you expect to receive \$1.5 million by condominiumizing it and selling it retail. Here, one should sell the property to another corporation at \$1.5 million to establish a new basis for the property and pay the capital gains tax on the differential between the purchase and the sales prices. Then the new corporation can sell the building at \$1.5 million — what they paid for it — and have no gain. Realistically, the IRS may challenge this process on the theory that the developer is attempting to do indirectly what he is not permitted directly to do. However, it is not clear that the IRS would succeed in such a claim.

Some have analogized to the case where one inherits a large piece of property with an old main house, a gardener's house, and a chauffeur's house on the land. The new owner may seek to sell the property piecemeal, for example, in 10 lots, since that is the only reasonable way to dispose of the land. But since he has sold more than five pieces of real estate in that year, theoretically he should realize ordinary income on the transactions. Half the cases conclude that if that is the only way you could salvage your investment then you are really not a dealer, holding that in such circumstances you did not intend to be a dealer. The other half of the cases hold that intention is irrelevant: all that is pertinent is whether more than five pieces of real estate have been

sold in any one year. This may be one of the areas where there is an advantage to going co-op, as opposed to selecting the condominium regime. By converting to a co-op, one apparently is fairly well assured of receiving capital gains treatment on the single sale to the cooperative housing corporation.

With respect to the conversion and the lack of mortgage money, there is one feature that one developer has used in a recent plan that is worth considering. We often give a 10 percent discount to the occupants to induce them to buy; this is fairly standard in the State of New York in conversions to either a co-op or condominium. In this plan the developer stated he would provide 75 percent financing to the condominium purchaser, whoever he may be. However, if the purchaser elected to obtain financing from a lending institution or use his own personal funds and purchase for cash, he would be accorded an additional 5 percent discount. This is a worthwhile approach, since it provides an inducement to obtain financing independent of the developer. Again, the convertor may be satisfied with getting 25 percent of the money up front and then having an 8½ percent mortgage on the unit as an investment.

Whether you could later discount that mortgage at any reasonable amount is somewhat problematical. It has been suggested that some institutions might charge 20 percent off of the face amount, so that if you had a \$20,000 mortgage you might only receive \$16,000. That represents quite a loss. In the plan I referred to previously, the developer reserved the right to pass mortgages along to any other lender in the future. One related problem is the prohibition against second mortgages contained in some condominium documents. This proscription is often found in the co-op field. You prohibit the pledging of stock which would in effect prevent the cooperator from taking advantage of a cooperative loan with the bank wherein the lending institution is charging 9 or 10 percent for 15 years. A prohibition against pledging is legal — certainly with respect to stock and lease. But if you tell an individual with a condominium who owns it in fee simple that he cannot borrow by way of a second mortgage, this *may* be illegal. There is no case on it.

Some condominium documents prohibit non-institutional financing and this has given some unit owners fits. A purchaser may want to take over the current owner's old mortgage and pay \$7,000 or \$8,000 cash; in this way he can get up to \$30,000 in financing. For example, let us suppose the purchaser takes over your mortgage of \$23,000, giving you \$7,000 in cash. Now he is up to \$30,000, which, in our hypothetical,

is what you paid for it. The problem is, you are asking \$35,000 for the unit. The only way he may be able to furnish that extra \$5,000 is by way of taking out a second mortgage. However, in some condominium documents, you run up against a provision that prohibits second mortgages on units.

Previously someone asked about the powers of the board of managers before the formation of the association. The association is not formed in New York by filing with the Secretary of State or any similar procedure; it is simply an informal association. At the time the New York Condominium Act was passed, the Legislature considered whether to allow the incorporation of the board of managers. They decided against it* — largely for fear of negative tax ramifications — *i.e.*, that you might have money bottled up in the corporation if there were excess assessments, and be taxed on your own money. Currently in New York to activate the association you merely notify the Attorney General's Office that the condominium plan is going to be declared effective. Do you do this by way of amendment, Arthur?

ARTHUR LEVINE: Yes, but I just want to point out that to the extent that you file the declaration of bylaws, filing is certainly not with the Secretary of State but with the County Clerk's Office.

PROFESSOR ROHAN: You cannot have a corporate association in New York.* You can in some other states by virtue of specific reference in the statute.⁸² Incorporation of the board does not really do you much good because the enabling legislation normally provides that if there are any common expenses for material, labor, goods, supplies, etc., the person dealing with the condominium can impose a lien on each unit.⁸³ Incorporation would not offer an opportunity to avoid such provisions. Secondly, since you own the common areas as tenants in common, you will incur joint and several tort liability. To meet this hazard, typically a liability policy is obtained. The point to remember is that incorporation will not diminish liability with respect to the common areas. The individuals on the board of managers will invariably insert in all their contracts a provision disclaiming personal liability as to third parties. As a result, a person who has performed services for the condominium is likely to hold the unit owners, rather than the board members, liable. There is also a new wrinkle. Within the last few

* By recent amendment, New York now permits incorporation of the board of managers if not inconsistent with the other provisions of the Condominium Act "and the nature of the condominium purpose." N.Y. SESS. LAWS [1974], ch. 1056, § 6 (McKinney), amending N.Y. REAL PROP. LAW § 339-v(a) (McKinney 1968).

⁸² See, e.g., ILL. ANN. STAT. ch. 30, § 318.1 (Smith-Hurd 1969).

⁸³ See, e.g., CAL. CIV. CODE § 1357 (West Supp. 1974).

months a company has started issuing officers' and directors' liability insurance for condominiums. I would strongly suggest that individuals who are going on the board of managers obtain that type of insurance. There are two exceptions to the policy. The policy will not cover lawsuits growing out of civil rights litigation. If an officer on the board discriminates against someone because of race, creed, or color the insurance company will not defend it, nor will it pay any liability. They will also not pay if your error or omission was a failure to buy any other type of insurance. If you forgot to buy fire insurance or liability insurance they will treat that as an error or omission relieving them of responsibility under the policy.

Someone asked about the role the title company plays. The title company, of course, does the title search. They will also check as to whether or not there are any arrears on common charges. If you are buying a unit on a resale, the person may be in arrears on his common charges. You will normally get a letter from the board of managers stating that all the charges have been paid up to date. If you do not get that letter, and there are past common charges unpaid, you, as the new unit owner, become responsible for the arrears. You would also get a letter from the board of managers stating that the right of first refusal has been complied with and waived, and the unit may be sold. The title company will except from coverage the declaration, bylaws and house rules. This is appropriate, because the person buying the unit is subject to the declaration, bylaws and house rules. However, you should get an explicit statement in a separate rider that the title company insures you against any loss in the event it is ever held that the condominium was not properly formulated. The title company will also, of course, check for judgments docketed, etc.

Most developers put a provision in the contract of sale to the effect that a purchaser only has six months to ascertain obvious defects and one year to ascertain latent defects, *i.e.*, defects that could only be found by living in the project. Such provisions are designed to limit the period a developer is liable for defects in construction. They also put in a provision that actions arising from defects relating to the common elements can be brought only by the board of managers. And in some plans they have also put in arbitration provisions to be used to avoid lawsuits where liability for defects is at issue. Has there been any definitive ruling in your office, Arthur, on whether such arbitration decisions are binding?

ARTHUR LEVINE: We have not said that they are not binding, but there is a non-binding arbitration clause that we prefer. We do not want

to foreclose anyone from litigating in the courts for the protection and the penalties provided they want to go through the expense.

PROFESSOR ROHAN: With respect to the resale right of first refusal, the requirement normally is that you will give the board notice of thirty days to decide whether or not to buy the unit at the same price. Invariably, they do not because if the board decides to take the unit off your hands they have got to come up with the price within one month, which means going back and assessing everybody or taking it out of the reserves. And when you have to pay \$1,000 each for the privilege of exercising this right of first refusal, you are no longer interested in the right of first refusal.

Ladies and gentlemen, if there are no further questions, the Workshop is concluded. Thank you.

APPENDIX

LEGAL AND MARKETING ASPECTS OF CONDOMINIUM DEVELOPMENT

Professor Patrick J. Rohan

- I. *Basic Outline of the Condominium and Unit Purchaser Representation*
 1. Legal and definitional aspects
 2. Conversions — Dilemma of the tenant faced with the necessity to purchase or face eviction (pending legislation in several states)
 3. New Construction — Almost total lack of regulation by the various states
 - Misleading advertising, including failure to list such heavy monthly costs as electric, heat and utilities (for example, listing only "exterior maintenance," mortgage costs and real property tax)
 - Underestimating common charges
 - Recreation leases and long term management contracts
 - SEC aspects and applicability of the Interstate Land Sales Full Disclosure Act
 - Poor construction and risk of loss of down payment
 - Lack of professional management in smaller projects and almost universal lack of a reserve fund
 - Lack of public understanding concerning the powers of the board of managers (e.g., Can the board borrow money?) and lack of understanding of the scope and effect of the "house rules"
 - Tremendous uncertainty as to the legal status of condominiums with respect to:
 - (a) The proper form of casualty insurance (fire and extended coverage) for the unit owner and group
 - (b) Unit owner tort and contract liability
 - (c) Right of unit owner to contest his real estate tax bill or condemnation award
 - (d) Applicability of zoning, subdivision and other laws, as well as private covenants & restrictions
 - Wide disparity in scope of title insurance
 - Widespread failure to employ attorneys by persons who would not purchase a house without an attorney
 - Problems peculiar to retirement village condominiums —

difficulty of reselling, rights of the estate of deceased unit owner, etc.

II. *Legal and Marketing Problems of the Developer of Condominiums*

1. Changing prices
2. Staged Development — building in sections
3. Multiple Condominiums with an umbrella association
4. Condominium versus Home Owners' Association arrangement
5. SEC and Blue Sky problems
6. Applicability of the Interstate Land Sales Full Disclosure Act (See 15 U.S.C. 1701 *et seq.*; 24 C.F.R. Part 1701; 38 Fed. Reg. 23866 (Sept. 4, 1973); 38 Fed. Reg. 27277 (Oct. 1, 1973))
7. Compliance with environmental protection legislation. See *Friends of Mammoth*, 8 Cal. 2d 247, 104 Cal. Rptr. 16 (1972)
8. Truth in Lending requirements relative to sponsor financing
9. Securing proper casualty and liability insurance coverage
10. Satisfaction of customer complaints — class actions against Developers

III. *Current Marketing Trends*

IV. *Commercial and Industrial Condominiums*

REPRESENTING THE CONDOMINIUM LENDER

William H. Parry

1. Short introduction to historical development of the condominium concept.
2. Chapter 82, Laws of 1964 — Article 9-B REAL PROPERTY LAW of the State of New York — the so-called Condominium Act (32 sections).
 - a. Definition as "real property" — REAL PROPERTY LAW § 339-g.
 - b. Investment powers of banking organizations — RPL § 339-ff, BANKING LAW § 2(11), 12 U.S.C. § 371, Comptroller's Manual for National Banks Section 2195.
 - c. Pertinent sections of the Condominium Act
 - (1) RPL § 339-e — Definitions.
 - (2) RPL § 339-i — Common elements — computation of interest — non-alterability — non-separability — non partition — exclusive advantages — access.
 - (3) RPL § 339-j — bylaws and rules and regulations — damages and injunctive relief — surety for future compliance.
 - (4) RPL § 339-k — alteration of unit.
 - (5) RPL § 339-l — liens against common elements and units.
 - (6) RPL § 339-m — common profits and expenses.
 - (7) RPL § 339-n — contents of declaration.
 - (8) RPL § 339-o — contents of unit deeds.
 - (9) RPL § 339-p — floor plan to be filed.
 - (10) RPL § 339-r — satisfaction or release of blanket mortgage.
 - (11) RPL § 339-t — withdrawal from condominium status — requirements — division of proceeds — payment of liens.
 - (12) RPL § 339-u, v — Bylaws and the required contents thereof.
 - (13) RPL § 339-w — books and records and examination thereof.
 - (14) RPL § 339-x — waiver of use, abandonment of unit, conveyance to board.
 - (15) RPL § 339-y — taxing of unit and its common element interest as separate parcel.
 - (16) RPL § 339-z, aa — lien for common charges and foreclosure thereof.
 - (17) RPL § 339-bb -cc — insurance and repair or reconstruction.
 - (18) RPL § 339-ee — other laws — particularly Article XI of the Tax Law — mortgage tax.
3. Provisions of Offering Plan, Declaration and Bylaws — examination by mortgagee — restrictive provisions — management — mortgagee representatives.
4. Alteration of Condominium.
 - a. Condemnation.
 - b. Fire.
 - c. Withdrawal.

FINANCING CONDOMINIUMS

Thomas H. Fegan

A. *EVALUATION OF A CONDOMINIUM LOAN APPLICATION.*1. *As to the Developer:*

His credit worthiness—does he have substantial funds of his own, or is he operating on a shoestring? His experience in the field—what other projects has he completed, and with what success?

2. *As to the Property:*

Where is it? Is it in a city where condominiums have been generally successful?

If it is a high rise, is it in an apartment building area? If it is a garden type, is it in a home area?

Are utilities and other amenities of sufficient capacity available—sewer, water, transportation, schools, churches, shopping?

3. *As to the Market:*

What is the vacancy factor for condominiums and apartment buildings in the area?

What competing projects are in construction or planned?

What are the rental rates for comparable apartments?

Are the proposed sales prices of the units competitive?

If there have been some unsuccessful projects in the area—why?

4. *As to the Improvements:*

The quality of construction.

Subsurface conditions as determined by soil tests.

The density of land use.

The completeness of plans and specifications.

The size of the units—both in area and number of rooms.

The common area improvements—clubhouse, swimming pool, tennis courts, etc., and how does the developer intend to handle them.

5. *As to Financing:*

What does the developer want—A land loan? A construction loan? Take-out unit loans?

What percentage of cost does he intend to cover with his own funds?

Can purchaser's deposits be used as a part of the construction cost?

What is the cost of the project and how verified—contractor's construction cost breakdown—land acquisition cost—taxes and interest during construction—advertising and sales expense? Over what period will units be sold?

6. *As to Documentation:*

Is the project, as established by the documents, fair to unit purchasers?

Do the documents protect a mortgage lender's position during construction and as a unit lender?

Are they satisfactory from a legal standpoint?

Are there any factors which will require an "SEC Registration?"

Are there any factors which will require a State or Interstate Land Sales Registration?

What type of advertising does the developer intend to use? Notwithstanding the condominium documentation, as such, will the advertising create any problems with the SEC or others?

If it is intended to advertise and sell in the State of New York, has provision been made for an offering plan to be approved by the Attorney General?

B. *EVOLUTION OF CONDOMINIUMS LENDING POLICIES.*

Early approach to financing.

Savings and loan associations.

Insurance Companies and Banks.

Joint Venturing by Institutional Lenders.

C. *CONDOMINIUM DOCUMENTATION.*

Hawaii leasehold units.

Florida recreational leases.

Management Agreements.
Protection of Unit Mortgagee.
Florida's Proposed Amendment of its Condominium Act.

D. *ENVIRONMENTAL REQUIREMENTS.*

California Environmental Quality Act.
Equitable Environmental Code.

E. *INTERSTATE LAND SALES FULL DISCLOSURE ACT.*

Statement of OILS policy regarding condominiums.

F. *CONVERSIONS OF EXISTING PROPERTIES TO CONDOMINIUMS.*

Structural Condition of the Property.
New Alabama Condominium Ownership.
Act Permitting Blanket Mortgages.